

IMPACT OF IMF/WORLD BANK POLICIES TOWARD RUSSIA AND THE RUSSIAN ECONOMY

Y 4. B 22/3: S. HRG. 103-508

Impact of IMF/World Bank Policies T...ING

BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED THIRD CONGRESS
SECOND SESSION

ON

THE RECENT ELECTIONS IN RUSSIA HIGHLIGHT CONCERNS THAT THE
CONDITIONALITY POLICIES OF THE IMF AND WORLD BANK MAY BE
HAVING AN ADVERSE IMPACT ON THE STABILITY OF THE RUSSIAN
ECONOMY AND THE VIABILITY OF RUSSIA'S MOVE TOWARD DEMOC-
RACY. IMF AND WORLD BANK FINANCIAL ASSISTANCE TO RUSSIA AP-
PEARS TO BE CONTINGENT UPON ECONOMIC REFORMS WHICH
STRESS REMOVAL OF PRICE CONTROLS, TAX INCREASES, BUDGET
STRINGENCY, AND THE FINANCING OF BADLY NEEDED SOCIAL SERV-
ICES

FEBRUARY 8, 1994

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



JUL 19 1994

U.S. GOVERNMENT PRINTING OFFICE

78-623 CC

WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402

ISBN 0-16-044231-1

IMPACT OF IMF/WORLD BANK POLICIES TOWARD RUSSIA AND THE RUSSIAN ECONOMY

Y 4. B 22/3: S. HRG. 103-508

Impact of IMF/World Bank Policies T...ING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

THE RECENT ELECTIONS IN RUSSIA HIGHLIGHT CONCERNS THAT THE CONDITIONALITY POLICIES OF THE IMF AND WORLD BANK MAY BE HAVING AN ADVERSE IMPACT ON THE STABILITY OF THE RUSSIAN ECONOMY AND THE VIABILITY OF RUSSIA'S MOVE TOWARD DEMOCRACY. IMF AND WORLD BANK FINANCIAL ASSISTANCE TO RUSSIA APPEARS TO BE CONTINGENT UPON ECONOMIC REFORMS WHICH STRESS REMOVAL OF PRICE CONTROLS, TAX INCREASES, BUDGET STRINGENCY, AND THE FINANCING OF BADLY NEEDED SOCIAL SERVICES

FEBRUARY 8, 1994

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



JUL 19 1994

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1994

78-623 CC

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-044231-1

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

DONALD W. RIEGLE, Jr., Michigan, *Chairman*

PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
JIM SASSER, Tennessee
RICHARD C. SHELBY, Alabama
JOHN F. KERRY, Massachusetts
RICHARD H. BRYAN, Nevada
BARBARA BOXER, California
BEN NIGHTHORSE CAMPBELL, Colorado
CAROL MOSELEY-BRAUN, Illinois
PATTY MURRAY, Washington

ALFONSE M. D'AMATO, New York
PHIL GRAMM, Texas
CHRISTOPHER S. BOND, Missouri
CONNIE MACK, Florida
LAUCH FAIRCLOTH, North Carolina
ROBERT F. BENNETT, Utah
WILLIAM V. ROTH, Jr., Delaware
PETE V. DOMENICI, New Mexico

STEVEN B. HARRIS, *Staff Director and Chief Counsel*
HOWARD A. MENELL, *Republican Staff Director*
PATRICK A. MULLOY, *Senior Counsel/International Affairs Adviser*
PATRICK J. LAWLER, *Chief Economist*
CINDY LASKER, *Legislative Assistant*
SAUL SINGER, *Republican Professional Staff Member*
PAMELA RAY-STRUNK, *Republican Professional Staff Member*
EDWARD M. MALAN, *Editor*

CONTENTS

TUESDAY, FEBRUARY 8, 1994

Opening statement of Chairman Riegle	Page 1
Opening statements, comments, or prepared statements of:	
Senator Bennett	3
Senator D'Amato	3
Senator Campbell	5

WITNESSES

Lawrence H. Summers, Under Secretary for International Affairs, U.S. Department of the Treasury, Washington, DC	5
Prepared statement	49
Introduction	49
The support strategy	49
Economic reform in Russia and Western support	50
Critiques of the support strategy	51
The lessons of recent events	52
U.S. support for Russian reform in the period ahead	53
Conclusions	54
Letter dated February 23, 1994, on IMF information disclosure from Senator Riegle	87
Response to written questions from Senator Riegle	92
Ambassador Thomas W. Simons, Jr., Coordinator of U.S. Assistance to the Newly Independent States, U.S. Department of State, Washington, DC	8
Prepared statement	58
Political reform in Russia	58
Economic reform	58
The social consequences of reform	59
Bilateral assistance	59
U.S. stake in success of Russian reform	60
Professor Marshall I. Goldman, Wellesley College, Russian Research Center, Cambridge, Massachusetts	24
Prepared statement	60
Response to written questions from Senator Riegle	98
Professor Jeffrey Sachs, Department of Economics, Harvard University, Cambridge, Massachusetts	28
Prepared statement	63
Professor Peter Reddaway, Department of Political Science and International Affairs, George Washington University, Washington, DC	32
Prepared statement	76
Response to written questions from Senator Riegle	97
Jude T. Wanniski, President, Polyconomics, Inc., Morristown, New Jersey	35
Prepared statement	79
Response to written questions from Senator Riegle	100

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Newspaper articles:

New York Times, January 10, 1994, "Visit to a Maelstrom," by Peter Reddaway	84
Boston Globe, January 14, 1994, "Clinton's hopes for reforms under Yeltsin ignore the realities," by Peter Reddaway	86
Letter from Senators Riegle, D'Amato, and Bennett to Secretary of the Treasury, Lloyd Bentsen, dated December 3, 1993	88
Letter to Senator Riegle from Secretary of the Treasury, Lloyd Bentsen dated February 2, 1994	90

IMPACT OF IMF/WORLD BANK POLICIES TOWARD RUSSIA AND THE RUSSIAN ECONOMY

TUESDAY, FEBRUARY 8, 1994

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 2 p.m., in room 538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

OPENING STATEMENT OF CHAIRMAN DONALD W. RIEGLE, JR.

The CHAIRMAN. The committee will come to order. Let me welcome all those in attendance this afternoon.

Today is one of those typical busy days in the Senate: we had a succession of 8 roll call votes this morning—which is an unusually high number—and we had both party caucuses (which take place at the lunch hour on Tuesdays) and we're having Leon Panetta of OMB presenting, at this very moment, the new fiscal budget for the Clinton administration taking place one floor above us in the Senate Budget Committee.

As a Member of that committee, I must return at some point so I can participate in the discussion. But this I consider to be a very important hearing that we're having in the Banking Committee today.

We're here to consider the critical issue of the condition of the Russian economy and the impact that policies pursued by the International Monetary Fund and the World Bank are having on that country.

For almost 45 years after World War II, the United States and other western nations opposed the Soviet Union's entry into the IMF and World Bank because it ran a non-market command economy.

After the collapse of the communist system and the breakup of the USSR in December 1991, Russia and the other Newly Independent States demonstrated an eagerness to implement pro-market reforms as a means to boost the standard of living of their populations. Western nations were eager to assist Russia and the other Newly Independent States with these economic reforms.

In 1992, the western countries designated the International Financial Institutions, namely, the IMF, World Bank, and the European Bank for Reconstruction and Development, to play a major role in promoting economic change in the Soviet successor states through their advice and their conditionality lending policies.

Original projections in 1992, by leaders of the International Financial Institutions, suggested that the IMF might lend as much as \$25-\$30 billion, and the World Bank \$12-\$15 billion, to the former Soviet states over the next 5 years. Such loans, however, were contingent upon IMF approval of comprehensive reform programs in each new state, including Russia.

In January 1993, Russian Finance Minister Fyodorov announced an ambitious economic and financial reform plan for his country. It included, among other things, extensive privatization, the removal of price controls, tighter restrictions on money growth, and the slashing of subsidies.

Unfortunately, a number of things went wrong with these economic reforms. Russian output has declined by almost a third of GDP over the last 2 years, similar to what happened in the United States during the Great Depression. Inflation has soared, reducing the buying power of the average Russian and making the purchase of food, fuel, and other basic necessities difficult for the bulk of the population.

In the December 1993 election, the Russian people sent a strong signal that they were very dissatisfied with their economic circumstance, as fully 43 percent of them voted for ultranationalist and communist candidates.

There seems also to be a growing inclination among government officials to slow down or even stop the economic reform process, as key economic reform-minded officials, including Deputy Prime Minister Gaidar and Finance Minister Fyodorov, have resigned from the government.

Meanwhile, the IMF and World Bank are holding back on most of their loans because Russia has failed to meet inflation control, budget deficit, and other targets that were preconditions to this assistance.

So the purpose of today's hearing, with all that by way of backdrop, is to help us understand just what has happened and what is happening now to the Russian economy.

There are two primary questions that need to be answered. One, what is the viability of the IMF's economic policies for Russia, and two, what sequence and series of reforms do the Russians need to implement to ensure successful economic reform.

And I want to particularly commend Senator Bennett for suggesting that the committee review this matter. He visited Russia this past autumn and did some important work there, and came back very concerned about what he saw. In fact, he and Senator D'Amato joined me in writing to Secretary Bentsen on December 3, 1993, voicing our concerns about the impact World Bank and IMF conditionality policies were having upon the Russian economy.

So our first panel of witnesses today is composed of the Under Secretary of the Treasury for International Affairs, Dr. Larry Summers, and Ambassador Thomas Simons, Coordinator of U.S. Assistance to the Newly Independent States.

Our second panel is composed of noted Russian and economic experts: Professor Jeffrey Sachs from Harvard University; Mr. Jude Wanniski, the President of Polyconomics; Professor Peter Reddaway, from George Washington University; and Professor Marshall Goldman from Wellesley College.

So we certainly have the witnesses here today that can help illuminate these issues and help us think about where our policy ought to go next.

Senator Bennett, despite the fact that we organize and run the committees in the Senate on the basis of party, as Chairman I have occasionally asked Republican Members to assume the Chair at different times. And at a later time, when I go to the Budget Committee, I'm going to do that today, and ask you to assume the Chair for this hearing as other Members come and go.

Let me now call on you for your remarks.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I appreciate the opportunity and I appreciate your confidence.

Senator D'Amato would like to have been here. He's tied up in one of the conflicts that you've described, and has submitted an opening statement.

Without objection, I would ask that it be printed in the record at this point.

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

I commend the Chairman and Senator Bennett for their leadership in convening today's hearing. The committee will hear from two panels of witnesses who will address the IMF/World Bank policies and their impact on the Russian Economy.

Our first panel includes: Lawrence Summers, Under Secretary for International Affairs at the Department of Treasury and Ambassador Thomas Simons, Jr., Coordinator of U.S. Assistance to the Newly Independent States at the Department of State. Our second panel includes: Professor Jeffrey Sachs of Harvard University, Jude Wanniski of Polyconomics, Inc., Professor Reddaway from George Washington University and Professor Marshall Goldman of the Harvard University Russian Research Center.

Last year, the United States poured some \$2.5 billion into the C.I.S. While we feared that if we did not provide this aid there would be a backlash, I wonder, in retrospect, if this would have mattered at all. I have long been concerned that injecting vast sums of money into a system that may be unwilling to fully reform itself is like pouring money into a black hole, offering little or no return for our investment.

If we are going to continue to provide assistance to Russia and the rest of the C.I.S., we must be mindful of how it is spent. Will the assistance provide the maximum benefit to the people of the region, or will it simply fund an ineffective program? I look forward to our witnesses answers to these questions as well as other questions before them today.

Thank you, Mr. Chairman.

Senator BENNETT. When I was in Russia, I was told, along with Senator Specter, that there are three economies operating in Russia, at least at that time. I understand that one of them has subsequently been outlawed.

There were a number of Russians who had the opportunity to move from a ruble economy to a barter economy. Those in the rural areas that raise their own food, as they went through the first ex-

perience said well, we're not ever going to do this again, and they simply got out of the business of dealing with currency and moved to a barter economy. We were told that constitutes a fairly significant part of the Russian economy.

The second economy is the dollar economy. They told us of transactions that were taking place, primarily among the new entrepreneurial class, entirely in U.S. dollars. We were told there were \$30 billion in United States cash in circulation in Russia, and that this constituted a major part of the Russian economy. We experienced a little of that ourselves during the period of time when we had an opportunity to shop. Everything we purchased, we purchased with dollars, and in every case, we were asked for dollars. No one even wanted to talk about rubles.

The third economy, of course, was the ruble economy. And as that was described to us by the country team, that was the one that was in the most difficulty. The only portion of the ruble economy that was working, we were told, was that portion that was still tied to government ownership and government control of jobs.

I remember the briefer who said, in the Brezhnev era, they didn't have anything to spend rubles on because everything was provided by the government. So they spent about 70 percent of their discretionary income in rubles on food.

Today, those who are still in the ruble economy exclusively spend about 80 percent of their discretionary rubles on food. So from that standpoint, it hasn't hurt too badly. As they are pushed away from a circumstance where their job provide them with housing, clothing, and transportation, and they have to depend on rubles to buy those things, they begin to move into a circumstance of great desperation.

If they cannot participate in the barter economy or the dollar economy, they are facing disaster. Now we understand that the dollar economy has been outlawed, and we don't know yet what the implications of that will be in terms of the lives of the average Russian.

The historical parallel that continues to haunt me, Mr. Chairman can be found at the bottom of this hill where we sit in the holocaust museum. If you go through that museum and you see the record of the rise of Adolph Hitler, you find that Adolph Hitler was treated as a crackpot, goofball, a footnote in history, as long as times are good in Germany.

As soon as hyperinflation hits and destroys the savings of the average German to the point where they have nothing, all of a sudden Adolph Hitler begins to gain traction politically, which ultimately produced the result that history has recorded.

I'm not here to say that Mr. Zhirinovskiy is a Hitler. But the conditions that existed in the Weimar Republic are hauntingly familiar to the conditions we are seeing in Russia today.

I want to see if there's anything the western democracies can do this time that we didn't do last time, to see that this very grim chapter in our history does not repeat itself.

As I hear the anti-semitic slogans, as I hear the nationalism talking about the defeat, this time not of the Versailles Treaty, stab in the back, but in the loss of the empire. On the streets of

Moscow, I get very nervous about the possibility of history repeating itself.

So I'm very grateful to you and to Senator D'Amato for your willingness to schedule this hearing and we'll look forward to the testimony.

The CHAIRMAN. Thank you very much.

Senator Campbell.

OPENING COMMENT OF SENATOR BEN NIGHTHORSE CAMPBELL

Senator CAMPBELL. No statement at this time, Mr. Chairman.

The Chairman. We'll proceed then with our witnesses.

Mr. Summers, we've got your statement. And also, Mr. Simons. We'll make the full statements a part of the record.

We'd like you now to go ahead and make your oral presentation and summarize to whatever extent you wish.

STATEMENT OF LAWRENCE H. SUMMERS, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, U.S. DEPARTMENT OF THE TREASURY

Mr. SUMMERS. Thank you very much, Mr. Chairman. Thank you and Senator Bennett for your initiative in holding this hearing at what surely is a crucial junction in the Russian reform effort and in the western support for that reform effort.

Senator Bennett stated, much more eloquently than I could, the rationale for extensive involvement and support for reform efforts in Russia.

There can be no more important geopolitical objective for the United States than ensuring a peaceful economic transition and a prosperous economic transition in Russia and in the other republics of the former Soviet Union and in Eastern Europe.

The support strategy of the Clinton administration has been predicated on the recognition that western support can help reinforce reform but it cannot determine the outcome of events. Thus, we have proceeded along a two-track strategy for supporting reform.

First, core support through bilateral assistance programs and through World Bank project lending is bottom up. It aims at creating the changes, support for privatization, repair of the infrastructure, improvement of the environment, creation of the institutions of a civil society that will make reform irreversible. And it continues independent of Russian budgetary conditions or the Russian inflation rate.

A second category of support, conditional support through loans from the International Financial Institutions, is conditional and aims at reinforcing reform through the top down tasks of stabilization and structural reform, which are carried out at the center.

It is conditioned on concrete steps toward reform, and the pace of support is measured at the pace of reform.

As you know, Mr. Chairman, last year, the G-7 developed a large-scale, multilateral support program for Russia that would provide Russia with up to \$28 billion, depending upon the pace of reform over the period from the first half of last year running through the first half of 1994.

Russia has achieved impressive gains in privatization and in liberalization of its economy. The macroeconomic stabilization has remained illusive with inflation rates still far too high.

I would conclude that 1993 was a year of modest reform and modest western support. In particular, the first steps toward stabilization which garnered initial IMF support did not lead to a full stabilization program. We cannot be satisfied with this outcome, and it is particularly important that Russia cut its budget deficit if it is to prevent a flood of money printing. Western support, especially for the IMF, we believe, can play an important part in managing this problem.

Three broad questions have been raised about the viability of this strategy.

First, some suggest that western support is wasteful because effective economic reform in Russia is impossible. We must not let the drama of political events obscure the fact that Russia has made real progress and is on the way to a market economy. Privatization has become far more widespread. Queues are a thing of the past with extensive price liberalization.

Second, some say that the west should stop pressing for bold reform and that a more gradual approach will be more successful. Throughout the region, bold reform has led to the best results. Compare Poland and Czechoslovakia with Rumania, or compare Estonia with Belarus and Ukraine.

It is no accident that where budget deficits, credit growth, and inflation have been controlled, superior performance follows.

You can look at the chart that is attached to my testimony to see the fairly clear relationship between success in bringing down the rate of inflation and success in spurring economic growth.

Some hold out the Chinese example as a model for Russian economic reform, but the conditions are too different to make the analogy useful. In particular, China is beginning as an agrarian economy, reliant on peasant agriculture. And this made the process of economic reform much simpler there, and afforded much greater possibilities for industrial revival than are realistic in Russia or Eastern Europe.

In any event, one has a test case for the gradualist reform strategy. The experiments with decontrol and partial decentralization in Eastern Europe during the late 1970's and the mid 1980's, which were supported by heavy western borrowing, and the Gorbachev experience in the late 1980's in Russia, which both led ultimately to the failure of reform and to unsustainable rates of high inflation.

I would conclude that reform is like a bicycle, far more likely to be stable if moving rapidly.

A third concern that is expressed is that western support should have flowed more rapidly in 1993. As I've said, 1993 was a year of modest Russian reform and modest multilateral lending. Higher lending, absent reform, would simply have produced money that would have flowed into Swiss bank accounts. Russia would end up with foreign debt and nothing to show for it.

What we wish had happened in 1993 is not that more money had flowed in support of the same policies but that the International Financial Institutions had been more effective in engaging Russia to

get them to take further policy steps that would have made possible a larger program of support.

Since December, many analysts have argued that the recent Russian election was a vote against reform and a vote against the strategy of support that I have just outlined. Clearly, the election was a setback for the reformers.

It is much less clear that it was a vote against reform. Few would dispute that the reformers ran a poor campaign. Zhirinovskiy had far more television time in the late stages than any of the other candidates.

Interestingly, the industrial lobby that advocated a strategy of maintaining production through subsidies to heavy industry did not even receive the 5 percent of the vote necessary to get proportional representation in the parliament. And opinion polls, even today, show that the average Russian is in support of reform and regards high inflation and not dislocations or unemployment as Russia's largest economic problem.

I conclude that recent events, including the election result, serve to indicate that our strategy, our measured strategy of core support that will proceed, no matter what happens, to create the institutions of a civil society and a market economy, coupled with conditional financial support, is the appropriate one.

In the aftermath of the elections, Russia has reached a critical juncture on the path to reform. At the Moscow summit, and again in recent weeks, President Yeltsin has reaffirmed his strong commitment to the market.

But other developments have raised questions about Russia's course. Leading reformers have departed the cabinet. Prime Minister Chernomyrdin recently set an inflation goal of 20 percent a month for the first half of 1994, and 15 to 18 percent in the second half of the year.

Later this month, Russia is to announce its 1994 budget. It will also issue a new statement. The choices Russia makes will bear heavily on its economic destiny.

Against this background, and reflecting what we've learned from the experience of the last year, we will aim to advance our strategy in the following manner.

First, bilateral assistance will remain at the core of our program in support of the development of market institutions.

Second, we will focus much more heavily than we have in the past on mitigating the social hardships of reform, primarily through the World Bank's involvement.

Third, we in the G-7 will closely monitor the policy decisions being taken in Moscow and work closely with the IMF and the World Bank to provide assistance as soon as it is warranted. The G-7 has an important responsibility in regard to this support. Later this month, G-7 finance ministers will meet with IMF Managing Director Camdessus, World Bank President Preston, and leading financial officials of the Russian government to underscore our commitment to intense engagement in the process of supporting reform.

Fourth, the World Bank should and will continue to help Russia meet its infrastructure needs. Project lending is essential for this purpose.

Fifth, we will do all that we can to support the other nations of the former Soviet Union. This is important in its own right, and is important for Russia as well, because one of Russia's many economic problems is the lost export demand caused by economic collapse in other parts of the former Soviet Union.

Thank you very much, Mr. Chairman.
The CHAIRMAN. Thank you very much.
Mr. Simons.

STATEMENT OF AMBASSADOR THOMAS W. SIMONS, JR., COORDINATOR OF U.S. ASSISTANCE TO THE NEWLY INDEPENDENT STATES, U.S. DEPARTMENT OF STATE

Mr. SIMONS. Mr. Chairman, I too welcome the opportunity to be here, and I congratulate you and your colleagues for making this session possible.

I am the substitute you mentioned earlier. Mr. James Collins, Ambassador Talbot's Deputy, was sent on another mission by the Secretary of State. That leaves me before you today.

Similarly, the short time period did not allow me to submit a written summary of my remarks. I have submitted a contribution for the record. Allow me simply to add a few comments in summary of what I submitted.

I think no one doubts the dangers or the stakes in the transformation that is taking place across these eleven time zones.

The Weimar parallel which Senator Bennett mentioned, I think is before us all. I happen to be a historian and take those kinds of analogies seriously. I also think there are very major differences between Germany in the late 1920's and Russia and the other new independent states today.

That was a decade after a devastating war with widespread social disruption, and it would be a situation comparable in Russia to the mid-1950's instead of the late 1980's and 1990's. I think there's simply a lot more wealth and solidity of structure there perhaps than there was in Germany in the late 1920's.

Second, fascism came to power in Germany in the midst of a worldwide depression. And the alternative models, the models of democracy and the market seemed, at that point, to be discredited everywhere.

I think we can say fairly that democracy and the market have been the great success story of the post-war period, so Russia has somewhere to look.

Finally, Germany, instead of being helped by the outside world, as Russia and the other Newly Independent States are, was burdened by reparations which it carried through the whole period.

So I think we probably ought to be careful of, as well as attentive to, analogies.

Mr. Chairman, my particular role is as coordinator of bilateral assistance. Secretary Summers mentioned this as one of the two tracks of our overall effort.

It is delivered in the situation he described. The Russian economy is a mixed picture of achievements and uncertainties, forward movements and setbacks, of the real turbulence that Senator Bennett referred to. So there are causes for concern and there are causes for hope. But, Mr. Chairman, this was also true before the

December 12 election and before the January cabinet reshuffle, as it has been true since. Those two events did not change that basic situation of uncertainty.

Our assistance effort is geared to the fluidity of the situation. It is a historic transition, historic in its magnitude and in the stakes involved. And it will be going on for a long time. So we are going to have to continue to expect reversals and setbacks as well as forward progress.

In that situation, our assistance effort is geared to the reform process, as Secretary Summers has described. Russia and the other countries of the area are attempting three revolutions simultaneously which, in many other countries, have been lived through and implemented in sequence: The transition from dictatorship to democracy; the transition from state-owned and centrally planned economies to economies based primarily on the market and individual choice; and the transition from empire to equal partnership among countries that are at peace with themselves, with their neighbors, and with the larger world.

We wish to use assistance to encourage and support all three of these revolutions, and it is for that reason that President Clinton has described forging a strategic alliance with reform and with reformers throughout the area, as his number one foreign policy priority. Assistance contributes to that larger objective.

It is tailored to the fluidity of the situation. It takes basically four forms.

Secretary Summers has described two of them, those that are geared to and dependent upon the reform process. Those two are support of the International Financial Institutions, when it comes to macroeconomic stabilization and restructuring, and support of reform that meets core needs. At a lower level, core needs are independent of the inflation rate and of the state of stabilization. That is the task of bilateral assistance. Both are dependent upon finding partners for reform, working with people in the area who are committed to making reform succeed. But the bilateral program does not depend on macroeconomic stabilization and the inflation rate.

The other two forms, Mr. Chairman, are not dependent on reform. One is resources from Nynn-Lugar funding to assist the four nuclear successor states of the Soviet Union in the safe and secure dismantlement of nuclear weapons and fulfillment of their international obligations.

And the fourth form is modest, humanitarian and technical assistance to all the countries of the area, as part of our effort to establish normal and productive relations with each. This includes exchanges, it includes support for trade and investment, it includes political dialog. It is the kind of relationship that we tried to develop in the 1970's and 1980's with reformist central and east European countries.

So three of the four forms of assistance, Mr. Chairman, can go forward without macroeconomic stabilization, and are not dependent on the rate of inflation. They can go forward and we believe that they should go forward in Russia and wherever else the reform impulse appears.

Our experience is that there are reformers everywhere, and that we should gear ourselves to policies, rather than to a few people.

The reform impulse in Russia and these other countries is produced by history, by the magnitude of the challenge they see before them, the challenges that history has brought to talented people and potentially rich countries.

There are reformers in various central ministries and in the parliament. As my submission makes clear, our judgment is that the new parliament is in fact fairly evenly balanced between reformers and deputies hesitant about reforms.

They appear at various levels of government. They appear in business. They appear elsewhere in society with the growth of non-governmental and private voluntary organizations. And they appear not only in Moscow, but in the regions. They come in all shapes and sizes.

There are fast reformers and there are slow reformers, there are robust reformers and reticent reformers, as well as anti-reformers and non-reformers. And they come in shifting coalitions and combinations.

There is plenty that can be done and that needs to be done short of the macroeconomic stabilization which we seek in coordination with our G-7 partners and the International Financial Institutions. And there is plenty that it is possible to do.

So with regard to our bilateral assistance, Mr. Chairman we intend to remain steady, we intend to help people where we can with our humanitarian assistance, and we intend to seek out and support reformers wherever we can.

There are some dangers in the reform process. Senator Bennett has described some of them eloquently, but we feel that the greater danger is to stand still, to withdraw, and that that is a danger that faces them and us equally.

Our resources are limited, but we do not have the luxury, we feel, of stepping back, so we intend to stay engaged, to stay the course, and encourage them to do the same. Thank you very much.

The CHAIRMAN. Thank you very much.

Let me raise with you some questions here.

First of all, let me just read an item off the front of the Wall Street Journal today that you probably saw. It relates to the larger economic context within which these events take place.

The headline of the article is "Unemployment Rises Around the World, and the Outlook Remains Dim." I'll just read part of it into the record.

More people are out of work than ever before. According to the ILO, some 30 percent of the world's labor force is unemployed or underemployed. 120 million people are registered unemployed and another 700 million are underemployed. Unemployment is forecast to reach 8.6 percent in industrialized nations by the end of 1994, the highest level since the Depression.

It notes the rate is projected to fall here in the United States. That's some good news. It says:

In the developing world, joblessness is worsening in most regions.

It goes on to lay that out. It talks about Poland and says:

Poverty has skyrocketed in Eastern Europe. In Bulgaria, 73 percent of all households were below the poverty line in 1992, up from 42 percent 2 years earlier.

Given Russia's economic stresses, and recognizing that parallels to other places and time periods may fit in some ways and may not in others, I would like each of you to comment on whether the fab-

ric and circumstances in the old Soviet Union—Russia particularly—are really going to hold themselves together here.

It looks to me as if there's a lot of deprivation. Some people seem to be doing well, but it may be that lines are shorter, for example, because people don't expect to get anything when they get to the front, and so they may not stand in line at all.

So I'm wondering if we really have the resiliency in Russia to stay on track in the long run with respect to these rather modest gains, and have everybody support such economic policy still.

Mr. Simons, do you want to go first, or Mr. Summers? Either one.

Mr. SIMONS. Mr. Chairman, I have a modest confidence that they can make it.

The CHAIRMAN. A modest confidence?

Mr. SIMONS. It's risky. You can't tell. I pick those words carefully.

My confidence is based on my experience in Poland. I was Ambassador for 2½ years in Poland between the fall of 1990 and the spring of this year. And so I lived through 2½ years of a rigorous reform process. The Poles had certain advantages, perhaps certain disadvantages, compared to the post-communist countries to their east.

Nevertheless, they had been a communist country, a centralized dictatorship with a centrally owned and planned economy, a very small private sector, a small middle class. And 9 months before I arrived, in January 1990, they put in the boldest and most comprehensive reform program, the one that most closely deserves the name of shock therapy of anything that has been applied in the post-communist world.

It was a very difficult and hard time. I lived through a very difficult and hard time with a lot of pain. They have come through it. They are not out of the woods yet. But Poland stuck to a reform program, a reform program which began by macroeconomic stabilization, by wholesale privatization of small enterprises, small service and manufacturing establishments and sales establishments, and by opening the frontiers to outside goods, which forced the remaining state industries to compete.

That was the original program. Then they filled in, during my 2½ years, with some of the legal and regulatory infrastructure that a functioning market economy needs: The tax system, the customs system, the normal regulatory and enforcement functions of a democratic state that any democratic state needs. And there was a lot of pain and there were strikes, I mean, huge strike waves. We had four governments in my time despite the solidarity of Solidarity, which took over in the fall of 1989.

Nonetheless, Mr. Chairman, the Poles are making it. Poland, last year, had the highest growth rate in Europe, not just in central and eastern Europe, but in all of Europe; admittedly off a lower base from western Europe but a tremendous success.

The Czech lands, which started a year after Poland, reached, I think, zero growth. In other words, they came out of the recession in 1993. By the time I left Poland this spring, the general appreciation was that a third of the population were better off, a third were not better off but had a realistic hope for themselves and their fam-

ilies of becoming better off if they worked hard and played by the rules, as President Clinton says, and a third of the population were worse off.

Now, of course, that kind of differentiation after the enforced egalitarian conditions of the communist regime where you had very low wage differentials, that kind of spread in incomes, is profoundly disturbing and causes political problems and resentments.

Nevertheless, if you have a situation where the political system or the two-thirds can concentrate on the third of the population can concentrate on the third of the population that is worse off, to try to provide adequate social security for genuinely vulnerable and needy populations rather than inadequate social security for the whole population, which is the situation in Russia, I think you have a shot at it.

Poland is doing better. I think the Polish transition is probably irreversible at this point, and I think Russia and the countries of the other new independent states have that same shot, and that shot is worth our support.

The CHAIRMAN. Mr. Summers.

Mr. SUMMERS. Mr. Chairman, I too would have responded by pointing to the success in Poland or by pointing to the success in Estonia and contrasting that with what's happened in Romania, what's happened in Ukraine, that have pursued more gradualist routes.

I would make just a couple of further points.

First, there is no alternative. There is, I would suggest, no alternative to trying to pursue the task of rapid economic reform. All the examples we have of trying, in this part of the world, under these kinds of governmental conditions, with these kinds of economies that were already heavily industrialized, all of the examples we have of gradualism are examples that involve more inflation and involve larger output declines, and that involve greater economic dislocations.

I think the lesson is not that one should go slower; the lesson is that we in the west need to do all we can to provide support that would mitigate the dislocations associated with these economic changes.

That's what the privatization and restructuring program that the G-7 agreed in Tokyo last year was all about, precisely to deal with oblasts where these economic transformations have wrenching consequences and risks.

The CHAIRMAN. Let me just stop you there. Because I think the impression we're getting is that the Russians are slowing down, and that we're not really doing very much on the margin to get that acceleration—to get the bicycle, as you said earlier, going fast enough so it doesn't tip over.

Despite what you say, policies coming out of Russia seem to be different. In fact, Russians seem to be slowing down reform and nobody's really stepping up to the plate in terms of doing very much to help the country.

Of the \$28 billion that has been promised to Russia from various sources, where are we in terms of how much assistance we have actually made available directly and indirectly so far?

Mr. SUMMERS. Let me just say, Senator, as we said last April in Tokyo, and as I said again here today, our belief is that direct financial assistance has to be conditioned on its being well-used.

Putting money into Russia so that it goes out to a Swiss bank account, leaving the government of Russia with a debt that has to be serviced, hurts; it doesn't help the process of reform.

Our goal is not to simply say that we have dumped out as much money as we can.

The CHAIRMAN. I understand.

Mr. SUMMERS. Our goal is, as I've said, to measure the pace of support with the progress of reform.

The CHAIRMAN. Of the \$28 billion, what part of it has been made available?

Mr. SUMMERS. There's an appendix to my testimony that goes through the numbers. I prefer to think about it in terms of \$42 billion, including the debt that was rescheduled. Of that, including the debt rescheduling of that, about \$22 billion has been disbursed. So if you leave out the money that has been disbursed represented by the debt relief, approximately \$7 billion has been disbursed, though I should emphasize that the period over which that support is contemplated runs through July 1994. And if the Russians take the necessary steps of a rapid program of reform, I'd expect that you'd see a significant amount of that disbursed over the next 6 months.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. I was just trying to clarify the Chairman's question. Can you give us a straight answer? How much money has been disbursed? And following on your other comment, what percentage of that do you think has ended up in Swiss banks?

Mr. SUMMERS. Approximately \$7 billion of the \$28 billion has been disbursed, and I think that because we were prudent in the disbursement of those funds, very little of what we have disbursed has ended up in Swiss bank accounts so far, although there has been significant capital flight from Russia over the last year.

Senator BENNETT. Thank you, Mr. Chairman.

I have a whole series of reactions to the things you've said and a bunch of notes. I will try to keep them as organized and clear as I can.

First, if I may respond to the historian. I agree with what you've had to say about the differences with the Weimar Republic, but I would riposte just to this extent.

We are dealing with a country that has just come through a devastating war. It was not a shooting war all the time, but let's make no mistake about it; we are dealing with a post-war mentality of a defeated nation, and the defeat occurred not in the 1950's; the defeat occurred in the late 1980's and the early 1990's.

You talk to the average Russian and you'll find that that's their mentality. They are mourning over the loss of empire. They are feeling very much distressed over the fact that they no longer have the kind of stability they had when they were a super power.

They don't want communism back but they would very much like to be a super power once again, and that's part of Mr. Zhirinovsky's appeal. So there is that similarity.

Second, again go down to the Holocaust Museum and you'll find the newsreels show the Germans in a state of great prosperity and doing just fine in the late 1920's. And Hitler was a joke in that period. He may have tried to come to power in the early 1920's but he was all but gone until the 1930's.

You say the world was all in depression. The problem in Germany was hyperinflation. We didn't experience anything like that in the United States where all capital was wiped out.

That gets me to my second point. I don't want to argue history with you, but I used that to get to the point. In all of the conversation we've had here today, no one has mentioned capital formation.

If we're talking about introducing capitalism, and that word has not been used either, we have to recognize that capitalism, as a system, is based upon capital formation. All wealth comes from capital formation.

And for 75 years, you can go back to the days of the Czars and maybe even for centuries before that, all capital in Russia was held by the central government. People weren't allowed to own anything at least for 75 years, except currency.

They didn't have any small businesses that they owned. They didn't have any farms that they owned. They didn't have any stocks and bonds that they owned. Their sole source of capital formation around which they could feel any kind of security was a ruble bank account. And suddenly, in the last 3 years, the ruble has been destroyed.

If we're going to talk in terms of capitalism, we say that what has happened, through the hyperinflation, is that we have destroyed whatever capital formation existed in the hands of the average Russian.

Now you talk about the Poles, Mr. Simons. You used the phrase, the privatization of small businesses, and that's very exciting to me because that means in the hands of some small people, there was something that represented capital formation. They owned something that had some intrinsic value.

Presumably, from my observation, the only people who own anything that has any intrinsic value in Russia today are those who hold dollars because dollars have maintained a stable value over time. Therefore, they can be held with confidence because, at some future point, they can be traded with confidence for a business, a farm, a building, an apartment, something that represents capital formation.

In all of this discussion, I haven't heard anybody talk about capital formation or maintaining a stability of capital formation on the part of people who are trying to get it.

Now you talk about shock therapy. I haven't followed the Polish example, so I don't know what was done to the Polish currency. But the destruction of the ruble, and therefore of the capital formation of the individual Russian I think plays a much greater part in this issue than we may have understood.

And, Mr. Summers, you say they've got to balance their budget. Well, if you're going to balance the budget in nominal terms, you can do it very easily by fooling around with the currency, printing money, and all the rest of that.

But in real terms, you're getting into great difficulty. Economies, unfortunately, don't run on nominal terms; they run on real terms.

The first question, after this statement of my reactions is what's the best way to balance the budget in a hyperinflation situation where the capital from which people would normally pay taxes has suddenly been destroyed and they're left with nothing with which to pay taxes?

Mr. SUMMERS. Senator, let me respond to that a little bit generally.

Senator BENNETT. This is a good place for general responses.

Mr. SUMMERS. And then come to your specific question.

If I might, I completely agree with you on the importance of capital formation and I completely agree with you on the evils of inflation. And I completely agree with you that unless the ruble is somehow stabilized, whatever happens with the rest of the stuff, there's going to be no durable and successful economic form and that a healthy economy has to be built on a sound currency.

I would approach the question of the relationship between the deficit and inflation in a somewhat different direction than you would.

The way I understand inflation in Russia, cutting through all the complexity, is that because the government runs a chronic budget deficit, and because that is it spends more than its taxes with ordinary taxes, and because there's only a limited capacity in this extremely unstable environment to issue bonds, the government has no alternative but to print money to cover that deficit.

And because it prints money at a rapid rate to cover that deficit, it gets rapidly growing money stock, too much money chasing too few goods, and it's that excess creation of rubles to close the budget deficit, to close the budget gap which is the primary source of the inflation that Russia has.

Now a successful approach to solving that problem, it seems to me, has two important elements. One important element, and I would argue the more important element, is that Russia has to take measures to spend less, to give less in the way of specific subsidies to specific industries, and to spend less on its military, and it has to succeed in collecting more taxes.

It has to succeed in collecting more taxes by enforcing the tax law that it has, by moving to the kind of taxes that work in a market economy, different from the kind of confiscatory taxes that it had in the socialist economy.

So a major part of the solution to stopping the deficit, which is the cause of the inflation, is the same kinds of things we do here; spending cuts, tax increases.

A second part, and this is where the role of the IMF—

Senator BENNETT. Let me interrupt you there. I'm sorry, I don't dare let that go.

We may have a philosophical difference here; indeed, I think we do have a philosophical difference here. You're saying the way to cut the deficit is to spend less and raise taxes?

I have a problem with that. I have run a business and the parallels are the same. If you're running at a deficit as a business, people say that you either have to increase your income or you

have to cut your overhead. Those are the only two ways you can do it.

The cowardly way that almost always happens in most businesses that I have seen that have failed is the way we increase our income is to raise our prices, which is the business equivalent of raising taxes.

Many businesses survive by cutting their prices, increasing their volume, and thereby their total revenue, and seeing their business pull out because of increase of sales. In government, that's called supply side economics. I know that phrase is in bad odor in many places.

But right now, as I understand it in Russia, there is an 80 percent tax rate on business. It seems to me that this is a strong signal from whomever it is coming that they do not understand how business really operates.

If you're going to have viable businesses in Russia, if you're going to have entrepreneurs in Russia, you're going to have to do what every other country that has successful entrepreneurs has done, which is allow them to keep a little bit of the fruits of their labors sufficient to not only pay for the growth, because a growing business eats cash, a growing business demands cash; tax people don't understand that but it's true.

And second, keep a little for themselves for their efforts. It would seem to me that one of the serious problems in the Soviet economy is to get the tax rate down, rather than up.

Before you move on to your second point, I think we ought to stop and talk about taxes for a minute.

Mr. SUMMERS. Senator, I think we disagree much less than you might suspect. After I said cutting spending, I did say raising tax revenues, and I said raising tax revenues by moving away from the kind of confiscatory tax systems characteristic of a socialist state toward the sorts of modern tax systems that underpin a market economy.

What I meant behind that gibberish was precisely low rates and a broad base, rather than the kind of punitive taxation of business that frankly has prevailed in Russia for some substantial period of time.

I agree with you completely than when you have effective tax rates of 80 percent on enterprises when, as in the case of some energy producers, you cascade the oblast taxes on top of the energy taxes on top of the Federal taxes, you actually get marginal tax rates in excess of 100 percent. And I agree you're not going to get anything going in those circumstances.

So I might better have spoken of tax reforms that would in toto create a tax system that would produce a healthier economy and a larger level of tax revenue, and then we probably would have agreed.

Senator BENNETT. I appreciate that. Is that kind of tax reform specifically part of some of the reforms the IMF is calling for? Are they specifically saying you've got to lower your tax rates?

Mr. SUMMERS. Absolutely.

Senator BENNETT. Would they even go so far as to say eliminate the capital gains tax as the Chinese have?

Mr. SUMMERS. I don't even know that there is a capital gains tax.

Senator BENNETT. I'm on one of my hobby horses. Thank you. Go on to your next point.

Mr. SUMMERS. I don't even know that there is a capital gains tax now in Russia. One of the things that the World Bank put a great deal of emphasis on in connection with its energy sector loan was precisely the reform of energy taxation.

Now this example actually points up the kind of dilemma that the International Financial Institutions and indeed the G-7 are confronted with. How large a tax reform to provide more incentives for oil producers should the World Bank have insisted on before it provided funds for the repair and reconstruction of oil properties?

Some people would say it shouldn't have demanded many conditions because it was very important to get support there. Other people would have said, well, the conditions should be very onerous because it's much better to have the private sector do this.

Clearly, you have to strike some balance, but when you strike that balance, you're going to say AID funds move but you're not going to see AID funds move as fast as they would if you entirely dispensed with the idea of conditionality.

The other point I was going to make, in terms of sources of support for the budget, was of course, that that's where foreign finance can play a major role.

When you have foreign finance, that's non-inflationary finance, that's a way of financing the budget deficit without resort to printing rubles. That finance makes it possible to have a budget deficit and not to run the kinds of inflation rates because you don't have to print money.

Of course, just as people argue, and I suspect, Senator that you are one of them, that tax increases in the United States won't reduce the budget deficit because the money's likely to translate into extra spending, so it doesn't really work.

One has the concern that if you simply provide foreign finance to the deficit, and you provide it without conditions, it will simply lead to extra spending, and you won't get the reduction in the inflation rate that you're trying to achieve.

But, broadly, the answer to your question of how do you get this inflation under control is you stop its fiscal roots in budget deficits. You do that by cutting spending and having a better functioning tax system, and cushioning the adjustments with external finance, all the while making sure that that finance is really conditioned on the changes in the deficit happening, because otherwise it won't do any good.

That's the essence of the approach that the IMF is taking and that the G7 is supporting. And I'm firmly convinced that that's the right approach. The problem is to do it better so that there's more reform and more money that flows.

Senator BENNETT. Thank you, Mr. Chairman.

The CHAIRMAN. Just a couple of more things, then we'll go to you. And when you finish, we'll go to our next witnesses.

Let me just say to the two of you, Professor Sachs contends, in his remarks, that the IMF's performance in Russia is inadequate. He calls for greater public scrutiny as to what's being done and argues that IMF documents ought to be declassified.

Now the IMF, for its part, asserts that it makes all of its documents available now to member governments, and they in turn can release them if they want to. If that's correct, why wouldn't it be well for the United States Government to release these IMF documents so that we can keep track of what's going on in their operations and actually know what's happening?

Mr. SUMMERS. I think that we need to work for more openness in International Financial Institutions. And indeed one of the things this administration has stressed, actually in the World Bank, rather than in the IMF, so far, is the need for much more disclosure of information on their project loans and what the consequences of those projects are.

I think, as far as the IMF is concerned, I'd be for moving over time toward more openness there too, but we're talking about very sensitive financial arrangements of a kind that have enormous consequences for speculators. So it has to be managed very carefully.

I would not support a U.S. strategy of taking information that was furnished to the IMF where the IMF told the government it would be kept confidential and the government furnished the information on that basis, and for the United States to simply unilaterally break that commitment by disclosing those documents. That would, I think, be irresponsible of us.

Over time, I think more openness is a good idea, but you're talking about things that are sensitive to speculators and that are involved in international negotiations.

For example, in countries all over the world, the IMF seeks to negotiate programs and plans with governments, and it provide support conditioned on governments going forth with certain budget plans. It's probably for those governments to announce those plans to their people, rather than for the IMF to announce the plans to their people.

Yet, the governments, because they want the external support, have to come to agreement with the IMF on a plan before they announce it to their people. So I think in that kind of situation, for the IMF to disclose the contents of its negotiations would actually quite unsettle the democratic process in the countries that it's working with.

But over time, would it be better if there's more openness, would it be better if there's more information so that, at a minimum, scholars could evaluate the kind of job that the IMF did? You get into the same kinds of issues that you do with executive privilege or with the secrecy of the deliberations of the Federal Reserves' Open Market Committee.

I'd say, having had some exposure to this, that there's a need for more openness and we ought to push things that way. But I think any kind of blanket everything-has-to-be-disclosed type of arrangement probably wouldn't be viable.

The CHAIRMAN. In my mind, as I listened to what you said, I can see a distinction between data that is given to the IMF by an individual government of some particular sensitive sort, and other data that the IMF gives to the United States but the United States refuses to release.

It seems to me there's a difference between those two things, and if you sort of commingle them, you end up by putting a blanket

over information. And if you separate them, it seems to me that we will be able to release information that allows people to draw inferences as to why the IMF might make a certain decision. But if you cloak all this in secrecy, you don't have much of a way to monitor what's going on, do you? You might, but what about the rest of us?

Mr. SUMMERS. As I said, I think we should move toward—

The CHAIRMAN. With all due respect, that doesn't mean anything when you say that. That's a sophistry statement. I've heard it a million times in 28 years here, that we should move toward something.

That's different than saying: "I feel that we ought to change this, so in 90 days from now, we're doing X, Y, and Z." You may be dead and buried before there's a change in this. You may want it, you may think it's a good thing, but just to say that doesn't mean anything if there isn't something tangible and concrete that goes with it. No disrespect to you but those words evaporate before they even get up here.

Mr. SUMMERS. Let me try to be more explicit, Senator.

I think it would be a breach of international obligations for the United States to disclose IMF documents that have been furnished to it in confidence, in contravention of the procedures that have been agreed in the IMF, so I would oppose that.

I think that the United States will support reforms in IMF procedures, that will result in, and I expect that it will do this within the next 90 days in the executive board of the IMF, that will result in greater disclosures of the IMF's process as it deals with individual countries.

I can't frankly, I'm not a lawyer, I haven't thought through the issues carefully enough to describe to you precisely what I think should be released and what I think should not be released, because I do think there are real and important issues of confidentiality.

I think much of the concern about confidentiality and the concern about monitoring performance can be met by releasing things with a lag, after they are no longer market-sensitive or politically sensitive, but quick enough that one can really evaluate the kind of job that's being done.

The CHAIRMAN. I want to ask you a different kind of question, considering our vantage point is obviously different from yours. We're wondering about how fast the bicycle's going and how much it's sort of teetering from side to side and whether it's likely to fall over. And so that gets to the question of, you know, what's the momentum of real reform, sustainable reform that's getting lift underneath the change in the economy in Russia?

The impression that we tend to get from all the bits and pieces is that the bicycle looks like it might be slowing down and becoming more wobbly. And some wonder if it's even tipped over.

Are we slowing down here? I mean, I'd like to get a sense as to whether we need to do something here on the margin that gives us a better chance for success.

Mr. SUMMERS. I think we've all learned that foreign policy by sound byte is a little bit dangerous, so I will not give you an answer in terms of the bicycle metaphor.

I am concerned about the progress, about the pace, of reform. There are good things. The reaffirmations of a commitment to reform, the fact that the privatization program is continuing. But there are also things, particularly in the monetary area, particularly in terms of the budget, that are disturbing to us.

One of the very important functions of the meeting that I referred to in my testimony between Secretary Bentsen, Chairman Greenspan, and their G-7 counterparts, their Russian counterparts, and their International Financial Institution counterparts is that it will be an opportunity to deliver very strongly the message that if the window of reform is open, support will be provided through that window rapidly, promptly and substantially, to reinforce reform.

But if there isn't reform, if there isn't progress in monetary stabilization, if there are conditions where the real interest rate is negative 30 percent, and some people will simply borrow rubles in order to get the only sure store of value, dollars, and to put those dollars in Swiss bank accounts, then you won't see support.

And that's the message, at root that Secretary Bentsen and his G-7 colleagues will be providing at this meeting at the end of the month. It is precisely designed to provide increased energy and to emphasize the importance we attach to reform and very substantial things that we're prepared to do to reinforce reform and to reinforce reform rapidly if it comes.

But to answer your question, yes, I'm concerned about what's happening at the stabilization side. At the same time, I'm reassured and encouraged by the fact that the process of creating a civil society and a market-oriented economy through stabilization, through entrepreneurship, through an increase in the number of small businessmen and the reduction in the number of people working for state enterprises, that that all is continuing apace, even with the difficulties on the financial side.

And as for our bilateral programs, which don't go through the budget and don't therefore have the possibility of ending up in a Swiss bank account, I think those bilateral programs are doing very important work in laying that kind of long-term foundation for the transformation, which is ultimately the most important thing.

The CHAIRMAN. Any comment, Mr. Simons?

Mr. SIMONS. Well, I agree with that.

Referring to Senator Bennett's comment on my Polish example, that massive privatization of small and medium shops, enterprises and firms was in effect a reform. It did not exist under the communists. It was something that the Poles did, and it had a revolutionary effect. It affected not only on market supplies, because it produced goods for the market where there had been no goods before in connection with currency stabilization, it made it harder for some to buy those goods, but the goods appeared. But it also provided the openings for those entrepreneurs, for the beginnings of a middle class, because it doesn't take much capital to start such a shop.

The same thing can happen in Russia and is happening in Russia. Of the 150,000 small enterprises of that size, I think 70,000 now, something at any rate over half have now been privatized. I

mean they are doing that. That goes forward. That is creating the reliable basis, I think.

Senator BENNETT. How many of those, if I may interrupt, how many of those are trading in rubles and how many in dollars?

Mr. SIMONS. Oh, I think overwhelmingly in rubles on that scale. I mean, there is a dollar economy but I think not for tens of thousands of small food and service establishments who don't have the dollars for that. And those are entrepreneurs that are growing. Starting small. Most of them, many of them will not become big capital but that's the seed bed in the greenhouse.

So at my level, the level of the core needs and the small scale institutional legal framework, that appears to me to be going forward. It's very various, in some areas very little in other areas more; but the movement proceeds.

Senator BENNETT. Thank you.

I want to hear the second panel, but I can't resist sharing with you a story that I insist on telling all my employees in any business I'm involved in that I think has some applicability here.

It's an old story so, if you've heard it, forgive me. I think it should be taught at every business school and at every university in the country.

It's the story about the president of the dog food company. He gets everybody together and he says, all right, I'm going to ask you a series of important questions and I want honest answers.

Number one, who has the best managed dog food company in the industry?

The look at each other, they look back at him, and they say, we do.

He says, all right, who has the best dog food to go with their management?

They look at each other, and they look at him, and they say, we do; we have all of these studies that prove that our dog food is the best dog food.

He says, who has the best advertising?

We do.

Who has the best marketing and distribution channel?

We do.

Who is the best financed and most stable?

We are.

He says, all right, I agree with all that. Now I have one last question. Why aren't we selling any dog food?

There is a period of embarrassed silence, and finally, from the back of the room, a new trainee that has just joined the company speaks up and says, because the damn dogs won't eat it.

Now, you may be right that we are doing the right thing, and we fit all of the criteria and the economic models are exactly the right ones, and the solutions we have are the correct ones. But there aren't enough dogs eating our dog food in this circumstance.

I would hope we would recognize that, and as you review the various policies that you described here, that you keep the dogs in mind.

Thank you, Mr. Chairman.

The CHAIRMAN. I'm just worried that we may get a sound bite out of this that says the Russians have refused to eat American dog food.

I gather that what you're also saying is that this is an extraordinary transition that we're going through. There are a lot of peripheral issues that make it even more difficult in terms of the slack in the rural economy, and you know, we're working our way through it as best we can. I mean, this thing could veer a lot of different ways. It may succeed, it may not.

I'm a little troubled by the Poland example because I think that Poland's coming on the end of this wave and with the things that were done there and the entrepreneurial spirits that existed, and so forth, I think that's a different case, in a sense, an easier case, an earlier case.

I don't minimize it. I'm simply saying I think you can't look at that and just say it happened in Poland and so let's watch it happen in Russia. I think you're talking about something in Russia that's different and more complicated, and I won't go into all of the differences because I don't think time permits that. But what I'm saying is that I think it's a much dicier situation in Russia today, and I think the consequences are much greater in terms of what happens if this thing does not succeed.

I think frankly we're not doing as much as we ought to do. With all due respect, I don't just say ourselves alone. I don't think the United States can do it all. But I think the response of the free world needs to be stronger—let's move away from the bicycle—to give a little more lift under the wings here so that this transition can take place and that this thing not crash. I think it is a very important historic moment. And it may well be that those of us in a position to help are not helping quite as much as we ought to.

Now, I couldn't agree with you more—if we're so unable in terms of how we channel help that it sort of makes its way into a Swiss bank account, then maybe we ought to be changing the mechanisms that we use to try to help those who need it.

I think somewhere between doing too little and money in the Swiss bank accounts, there are other options here that probably are stronger and quicker, and that might be something we ought to be considering at this point. That's just my intuition at work here.

Senator BENNETT. Just one thought that you've triggered, Mr. Chairman.

I'd like a comment, and again I want to move on to the next panel. But if we could get a quick reaction to this. Why is it necessary for there to be government involvement in every circumstance?

Example. Back in the 1920's, 1930's, the Arabs opened up their oil fields and gave out a bunch of oil leases to American oil companies. All of the investment went in. It was immediately turned into capital. None of it was siphoned off into Swiss bank accounts. All of the money that was invested was invested by foreigners and simply by forming Aramco, the money flowed back into the country. The infrastructure was built by the American oil companies, and roads were built by the American oil companies, the expertise was

provided by the American oil companies because they could make a buck; indeed, they could make a very significant buck.

The Soviet Union used to be the world's largest producer of oil. What would happen if we simply said, OK, open it up for leases, and joint ventures and partnerships and the government won't do anything but enforce the rules.

I realize that might be a problem here. They don't have a legal tradition that some other countries do. Let's let foreign investment come in and build the country and not worry about channeling anything through the government at all. After all, it was British capital which built the railroads across this country; it wasn't American capital, and it didn't channel through the government. It was all done by people looking to get a return on their investment. Can you respond to that quickly, and then I will shut up so we can hear the next panel?

Mr. SUMMERS. The King of Saudi Arabia provided a stable environment with a stable currency and a promise of no confiscatory taxes. That's what's needed here if you're going to avoid, if you're going to attract private investment. No question about it. That's the best way to get hard currency into Russia and that's exactly what we have urged and have urged repeatedly. And the kind of credible environment that will engender business confidence is not yet there in Russia unfortunately.

If I could just say something in conclusion to Senator Riegle, as well.

I hope that in defending the course that the administration has embarked on, that nothing I have said suggests either complacency about the situation or complacency about the nature of our effort.

This is a critical juncture; it is absolutely essential to get it right, and to do everything we can, and we are constantly evaluating what we can do to be as constructive as possible, and to find the right road between not having helped when help would make a difference, and providing help that would end up being counter-productive by saddling them with debts and not doing what we're trying to do.

I hope very much that we have not left any impression of complacency about the situation.

Senator BENNETT [Presiding]. Thank you both. We appreciate your being here, your candor and your responsiveness.

We'll now move to the next panel.

[Pause.]

Gentlemen, you've been very patient, listening to the exchanges on the first panel. This will move more quickly because I don't have an opening statement and there are no other Senators present.

[Laughter.]

Senator BENNETT. That automatically increases the speed with which we move.

You have arranged yourselves, so I'll introduce you for the record and to the audience in the order of which you have done so.

Professor Marshall Goldman is from the Wellesley College, Russian Research Center in Cambridge, MA. Next to him is Professor Jeffrey Sachs from the Department of Economics at Harvard University in Cambridge, MA. The folks from Massachusetts seem to be outnumbering us here.

Professor Peter Reddaway is from the Department of Political Science and International Affairs at George Washington University. Then there is Mr. Jude Wanniski who is President of Polyconomics, Incorporated in Morristown, NJ.

We'll start off then in that order and I would ask you to summarize your statement. Let's try to hold it to 10 minutes, then given the somewhat freewheeling nature that we've seen in the first panel, I think we'll have plenty of opportunity to exchange back and forth, not only from the committee to the panel but within the panel itself.

Professor Goldman, welcome and thank you very much for being here.

**STATEMENT OF PROFESSOR MARSHALL I. GOLDMAN,
WELLESLEY COLLEGE, RUSSIAN RESEARCH CENTER, CAM-
BRIDGE, MA**

Mr. GOLDMAN. Thank you. I'm Marshall Goldman, Professor of Economics at Wellesley College, and Associate Director of the Russian Research Center.

I must say that, just as a general orientation, my statements may very well be regarded as defeatist, although what I'm about to say now begins with the opposite approach.

Who lost Russia I think is an inappropriate question and former President Richard Nixon's posing the question the other day I think has got us off onto the wrong foot.

I don't think anyone lost Russia. I don't think it was ours to lose. I don't think it was the G-7's to lose, I don't think it was the reformists to lose. The problem is that Russia is just simply too difficult a challenge for economists, political scientists, or government officials to work with.

As a perspective, the Germans are now spending \$100 billion a year for East Germany, so far with relatively meager results. How much more would be required if you're talking about external finance or external aid for Russia?

What I think we've failed to appreciate is that no reform or aid package would have worked as quickly as we expected it to work. We created false expectations for ourselves and for the Russians. That's not to say there cannot be reform, but it is to say that if there's going to be reform, it's going to take several decades.

Why? I don't mean to be too pedantic, but I think the important thing to understand here is that Russia is very different. Its history is different, its pre-revolutionary history, it was much more isolated, much more insular. Communism of 70 years has also made a difference compared to the other countries which had it.

It's also important to understand that pre-revolutionary Russia was a much more self-sufficient kind of society, insular as I said. Eighty to 90 percent of the population was agricultural and it's not only that it was agricultural, but it was also self-sufficient. It dealt very little in the market so there wasn't much of a market mentality, much of a market infrastructure that had to be destroyed.

In addition to which there also was a portion of population, a substantial portion, which had been called Slavophiles, meaning that they look inward. They are not eager to engage in western interaction or western type of activity. They regard it as vile, as

corruptive, and indeed they looked inside Russia to the church and to their own peasantry. That's one factor.

The second factor, as I said before, is Marxism and communism. The Stalin leadership, even beginning for that matter with Lenin, purposely designed their system so that it would never revert back to a market system or even to democracy. They tried to do several things in order to make sure that would not happen.

On the one hand, they tried to recondition the spirit, the attitude. Private trade was regarded as an antisocial act. Anybody caught producing goods, selling goods privately, was charged with an economic crime. Economic crimes were punishable by death. That tends to dissuade you from engaging in private activity.

Their history, as I've just described, plus the communism led to one of the stories that's often told, explaining this attitude.

The genie comes and says, I have three wishes, what do you want.

He asks the Frenchman. The Frenchman says, I want my chateau, I want my vineyard, and I want my mistresses.

What do you want, he asks the American.

The American says I want my corvette, I want my handgun, and my private home.

What do you want, he asks the Russian?

The Russian says, my neighbor has a goat. I don't have a goat. Kill my neighbor's goat. And you don't get much capital formation that way.

[Laughter.]

Mr. GOLDMAN. This attitude can be changed but it's going to take much longer than it would in other societies where they have much more interaction and a much different approach.

Even more important, though, was the restructuring of institutions. They believed that socialism and central planning was more efficient. Capitalism was wasteful. What do you need four gas stations on one corner, they ask. In principle, one large gas station would do. Of course, in fact, they often ended up with no gas stations on any corner, but the theory was a very good one.

Turning their back on capitalism they opted for communism, which meant state ownership. This would allow them to benefit from economies of scale. That's what capitalism would lack because it had to have competition. To have economies of scale, they decided they would abolish all small shops, all small activities, all small farms. They would collectivize.

They basically destroyed the marketing infrastructure. That was gone, and that was not something that was going to be rebuilt overnight.

Instead, they built monopolies which they prided themselves on. Seventy percent of the machinery produced, for example, in Russia, is made by monopolies. The factories were gigantic. Gigantomania, they called it.

Over 76 percent of all the factories had a work force of over 1,000 or more. In our country, it's about 22 percent. Some of these factories were as large as 100,000 people and very often those factories then provided everything in the community; housing, health care, and schooling.

Indeed what they did is they boobytrapped the system so that if anybody tried to untangle it, they would blow up the whole system and create enormous difficulties.

And when Gorbachev did away with some of the ministries and with Gosplan (the central planning organization), which in effect was the wholesaling infrastructure, they left a vacuum. There was nothing there.

So what you had then was these industrial dinosaurs and these industrial dinosaurs were designed so they could not compete in a market environment where you wanted competition. And this was, as I say, the sole source of many of the social activities in some of these communities.

Now what's happened?

Well, beginning in January 1992, when the Yeltsin Gaidar group took over, they faced some very dangerous situations. In my mind, however, they should have realized that the situation could not be remedied overnight. It was going to be a very long and difficult process. And it seems to me that they should have settled for much less. That means gradualism, some of the things that were just attacked by Secretary Summers in the preceding section.

But in the short term, you simply couldn't do that. If you introduce price relaxation, liberalized prices in that kind of environment, where there was not the institutional structure to take advantage of it, you're going to get an inflation that was higher than it would otherwise be. Certainly it was higher than it would have been if there had first been a currency reform.

They should have destroyed some of the currency that was an overhang from the Gorbachev era. What happened is that they indeed did raise prices which chased away potential consumers, but they didn't generate the additional supply that was necessary; that did happen in Poland.

But in Poland, as I will try to explain, 80 percent of the farms were never collectivized. Moreover, 10 to 15 percent of the society was operating in a private basis.

And so what happened is that, instead of emphasizing in the very beginning, the creation of brand new enterprises, new farms, private farms, new shops, new factories, they simply went ahead focusing on the monetary and fiscal measures. That's not to say they were opposed to creating new institutions but the main emphasis on a microbasis was on privatization.

But in my mind, privatization is not the same thing as creating brand new businesses, creating brand new green field businesses, creating the capital infrastructure that you were talking about. Because if you privatize, you are privatizing these industrial dinosaurs and they operate much as the state industrial dinosaurs did before.

What should we expect now?

Well, some progress has been made and I wouldn't deny that for a minute. Some privatization has been good, but for the most part, it's created the underside of capitalism.

Crime is rampant. Seventy to 80 percent of all private business and banking activities are now controlled by the Mafia, because you've got a distorted form of activity. You don't have that much

in the way of new green field business formation, certainly like you did with China.

I dispute Secretary Summers again. In my mind, what happened is that China is a relevant model. They didn't have the inflation to worry about when they started, but immediately created private farming and private services. You don't need much in the way of capital investment to finance this. In contrast in Russia because of the failure to provide new outlets the economy is distorted and one of the consequences of this underside is that we now have a Zhirinovsky.

I do expect more inflation. I do expect more direct control, a kind of a return to the old way, because for many people in the country, the new way didn't work.

It is possible the removal of the reformer could bring some positive results. I'm not expectant, however; I don't think it will, but it could. It could allow for some settling down, and if the legislature would allow it, it could allow for some private farms and shops. But for the most part, they're opposed to it. This is the backlash that has resulted in the aftermath of what I feel is a failed experiment.

Still, there will continue to be a capital outflow. The capital outflow that was discussed before, some estimate now to be \$1 billion a month. Whether it's from our money or not, we don't know. But we do know that it's continuing to go out.

We also do know that you can't create the private oil fields you were talking about, not because western oil firms aren't interested in going in there and investing, but because the Russians say we don't want western firms. There's a nationalism going on now that says we don't want these foreigners taking over our control.

So what is happening?

We are seeing, on the political side, a recreation of the Soviet Union bit by bit. Pieces of it are coming back. I don't say that we'll see the old Soviet Union intact but we'll certainly see more than we were led to believe would happen a few years earlier.

Just before I conclude, I would also say that I'm worried about Yeltsin, as well. I'm not sure Yeltsin will last the full 2 years of his term. I think that Yeltsin should have run for an election to recertify his credentials, to get a mandate.

Instead, now we find him not paying much attention in dealing with state issues. We're worried about his health, we're worried about some of his social behavior, and that's a very worrisome thing because it looks like Chernomyrdin, who commits himself to reform but has a very different version of reform than I do, is taking over control.

What should we do?

If we give international aid, it seems to me we have to be very demanding on how it's used. I don't feel at all that we should just give it to the Russians and say, go do what you want with it, because it has to be project-oriented. Otherwise it indeed will flow out of the country.

And if we want to be more lenient with the way we give money, it seems to me that instead of bashing the IMF, which seems to me to have other purposes other than just serving Russia, we should create a brand new organization and establish more lenient

terms, just like we created the European Bank for Reconstruction and Development to focus on Eastern Europe and Russia.

And we should avoid giving foreign aid money as we're doing now to the beltway bandits. It often seems to me that we give as much aid to American firms right now, as we give to Russia and I look for a scandal down the road that's going to upset the American taxpayer.

In sum we should focus on microchange. I do think we should try to support more of the kinds of things that are being done by the Enterprise Fund, the Russian-American Enterprise Fund as well as more support for the Ukrainian-American Enterprise Fund. We should create a farm fund. That's how you get the new capital structure that you're talking about. We should also create a marketing fund. Why don't those goods move? Because there is no wholesaling activity out there.

How do you break through the Mafia? You do it the same way you broke through the American Mafia after prohibition; by creating so many institutions they simply can't control them.

And finally, I think you have to say that we should not believe in a quick fix. It's wrong to blame others because they haven't achieved a quick fix. It's not an MTV environment; that's more realistic but not as exciting.

Senator BENNETT. Thank you. That was refreshing and direct and easily understood. I congratulate you.

Professor Sachs.

STATEMENT OF PROFESSOR JEFFREY SACHS, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MA

Mr. SACHS. Thank you very much.

I'm frankly not quite sure where to begin. But I thought I would begin with one comment that I disagreed with of Professor Goldman's.

I agreed with much of the rest he said, but I thought the comment, for me, really characterized a very different view of things. He said that the reforms had created a backlash now so that there was opposition, say, to private farming.

My understanding is, and I've been on the ground there for many years, there's been opposition to private farming by the communist elite all along. It was the thing that was most opposed by the old guard. It was the step to private land ownership that was most heatedly fought in the old Supreme Soviet of the Soviet Union. It was the step that Yeltsin could not get through the Russian Supreme Soviet. It was the constitutional amendment that he couldn't get changed.

The idea that this opposition, which is deeply, politically rooted in the power structure, which is quite entrenched and more entrenched now rather than before. The idea that this political opposition is somehow a backlash to a couple of years of a group of reformers trying to do something, mainly about price stabilization and liberalization, I find both preposterous but par for the course, unfortunately, in American discourse.

The situation, the crisis didn't start in January 1992. The Soviet Union collapsed because of a defunct and despicable system. The reforms, the need for fast reforms of various sorts didn't just start

out of somebody's imagination in 1992. It started because Russia was on the brink of collapse and indeed is in collapse, I would say, right now. And that was already true in 1991 when the Soviet Union fell to pieces.

And what one has to understand is what the struggle has been all about. It isn't just a theoretical exercise, do this kind of reform, do that kind of reform.

A rather unfortunately small group of key cabinet ministers, in the last couple of years, were trying to prevent a very deep and growing crisis from getting completely out of hand. They made some progress and they have failed in other areas, and I think the crisis could still get out of hand. But it's very important to understand why they came, what they were trying to do. And I'll just spend 2 minutes hoping to make that clear.

Before Yegor Gaidar ever arrived on the scene, before Yeltsin was President of an independent Russia, there was already a repressed hyperinflation in Russia. They'd already printed money with abandon for years. It had been kept under artificial control by price controls, and those price controls meant that there were no goods in the shops. By the end of 1991, the entire supply system had already collapsed before anything was done.

One of the reasons why Gaidar decided to move quickly on price liberalization wasn't reading a textbook on supply and demand, frankly, but it was the fact that first the black market value of the ruble was already 100 to 1, 100 compared to 1 at an official rate. Before he did anything, the ruble had already been completely gutted of value.

And even more to the point, the procurement of grain at the end of 1991 was a tiny fraction of target so there was real fear of hunger in the city, and not for any deep reason but because the black market price of grain was several times the official price by that point.

So farmers were hoarding, they were smuggling grain out to the Middle East, they were smuggling grain out to Europe. We were shipping emergency grain shipments and others were smuggling it out. And it was because of price controls that had become so severe, given an underlying money machine that was churning out rubles and making them worthless, and artificial price controls, that the whole official system, as it were, had completely collapsed, even putting aside the fact that the power base behind that system had also largely collapsed.

The moves were made in an urgent circumstance and they were urgent moves indeed. And I believe there were very few choices, and I also believe that the struggle was a rather clear one, and it has not been, on the whole, successful for reasons that I'll try to explain briefly.

But the main struggle I think you, yourself, said, Senator quite quickly, and that is that the underpinning of any viable economy and the stop of a freefall had to be to make a viable currency and to have a ruble that was holding value of some sort, rather than one that was moving quickly into hyperinflation.

The budget deficit at the end of 1991 was already about 25 percent of GNP; by some estimates, over 30 percent of GNP.

Marshall already said that the monetary overhang was phenomenal, but it was the flow of new printing which was also extraordinary.

By the end of 1991, there were also 15 independent central banks, all printing currencies, because as the Soviet Union collapsed, the central bank, Gosbank offices in the various republics all took it upon themselves to issue ruble credits independently, and these credits were accepted in cross payments. And so you had 15 central banks all issuing the common currency and all doing it pretty much at a hyperinflationary rate.

Now this, I think, was the urgent situation. It wasn't a question of whether Russia became a market economy in 3 years or 4 years or 5 years or 10 years; the question, in my view, has always been: would Russia succumb to hyperinflation that could have devastating consequences for the society and for us.

Because my own view is that hyperinflation is the single worst malady that can befall a society in peace time, and that the consequences are so destabilizing that it could lead to profound global danger.

I've regarded my task as 2 years as an advisor to Yeltsin and to the reformers, Minister of Finance Fyodorov, in particular, in the past year, and Gaidar the year before that, as doing the best to avoid hyperinflation.

Now I've seen hyperinflations, and I've advised five governments that successfully ended hyperinflations, and I think that there is a fairly basic course of action.

You want to stabilize the value of the currency in international terms.

You need to stop the printing of money. That involves, to some extent, reducing the budget deficit, and to some extent, finding other ways to finance it, including domestic bonds, which can be issued in a viable domestic context, and international borrowing.

And so these procedures I regard as rather understandable and just in the last 4 years, Poland, Estonia, Slovenia—I'll mention three countries where I personally worked—have been able very quickly to end hyperinflation. That, I think, has been the primary goal.

Russia, so far, has succeeded in avoiding hyperinflation but just barely. Ukraine, next door, is already in open hyperinflation and I think it's putting its sovereignty at risk, and it's even putting peace in the region at risk.

Because when a state can't even provide the basic public good of a currency, nobody wants to belong. So you get Crimea going out, you get the eastern part of Ukraine now more agitated to rejoin Russia. And these are the fissures that could create war. So I think the finance can turn into disaster.

The reformers were able to stop a hyperinflation by pressing the central bank, which they didn't fully control, to stop rampant printing of cheap credits and by, in part, getting the budget under control.

It has been my view, though, in the last 2 years that the west could have provided a great deal more sway in getting the right policies in place by combining far larger steps in Russia with real

and significant financial assistance from our side. And that there was more to be negotiated between us and them.

To me, watching this process, participating in it for 2 years, I see it not as a coincidence that the money didn't flow and the reforms didn't get done. And I also don't see it as a necessary sad fact of history; I see it as a failure largely of the G-7 and the international institutions' response to this.

Because I believe that the mechanisms of coordination with the Russians were completely inadequate. The number of contacts that were maintained were ludicrously small. The way that the aid was announced but not really worked on to be delivered I think was tantamount to saying that it wouldn't come at the end. And I believe that the International Monetary Fund has gotten a free ride in this by failing to have true professional independent scrutiny in this process. I think they've done a miserable job, as I've said on many occasions.

This isn't a question, I want to stress, Senator, of whether to have conditionality or not or whether we were too tough or not; we just did a poor job, I think, in designing the nature of the framework in which our aid and their reforms were to go together, again with the goal being to make a table currency as a prelude to any kind of economic recovery and social stability.

In my testimony—and I don't have time; I've exhausted my time—I go through at least I hope an intelligible discussion of why this isn't merely the question, as the IMF keeps putting it or even as the administration puts it, that we put conditions, they didn't meet them, we couldn't give them aid.

That is, I believe, a vastly over-simplified and actually misdirected answer to this issue. I think our framework was wrong, our dealings with the most senior officials of the Russian government were wrong. They could have done more. We could have done a lot more. We missed several opportunities.

I think the time is serious—that we've reached a serious and risky point right now. Russia is not lost but the situation is more dangerous, and at least if you keep your eye on hyperinflation as being a trigger of social unrest, one has to have a lot more fear now than even 3 or 4 months ago.

Senator BENNETT. Thank you.

I'd just ask you one quick question before we hear from Professor Reddaway.

Do you share the fear that the additional support that you called for would in fact end up in Swiss bank accounts?

Mr. SACHS. Sure, that's a risk, but I think that it could be reduced significantly.

See we sit here arguing what to do. We almost don't do anything to talk to the Russians themselves, and this may sound weird and also not true, but it's basically true. The extent of our discussion at the most senior levels is very thin. The ways to safeguard the use of funds is almost not discussed.

The IMF meets at a middle level, and the IMF goes every month or 2 months, they look around, they say, gee, this is a confusing, complicated place, which indeed it is. But they're at the wrong level and they're approaching it bureaucratically. They're not approach-

ing it with the kind of political weight, G-7 weight, vision and money that they have to approach it with to get the job done.

So these are risks. And one of the ways to solve some of those risks is that one can actually get Mr. Chernomyrdin and Mr. Yeltsin to sign on the line with respect to some very principled points of policy. That's not done. Our discussion just doesn't take place at an appropriate level, in my view.

And that's why, I may add, Senator, we can have a summit where five minutes after the summit, everything seems contrary to what was just said. Because the nature of that discussion was not with the depth that one would like, and that's why it happened. Because we simply haven't had the kind of commitment of senior effort that one would require to really make a \$28 billion aid program, for example.

That's a lot of money. You really want to safeguard that. You want to have the ideas. You can't do that by having a 7-man mission from the IMF go every 2 months in the name of the west, when it's not even their money. That can't be a way to operate. And that's why we have this complete misunderstanding. Reform, sure reform's going on, then all the reformers are fired.

How can that happen in a summit?

Well one reason is that there was very little depth of discussion beforehand. We were spending all our time whether it was more shock, more therapy, less shock, less therapy, less shock, more therapy, or more shock, less therapy. But we weren't engaging with the Russians.

Senator BENNETT. In other words, nobody was checking on how the dogs felt about it?

Mr. SACHS. Well, I wouldn't use that metaphor but I understand the point of the story.

Senator BENNETT. OK, thank you.

Professor Reddaway.

STATEMENT OF PROFESSOR PETER REDDAWAY, DEPARTMENT OF POLITICAL SCIENCE AND INTERNATIONAL AFFAIRS, GEORGE WASHINGTON UNIVERSITY, WASHINGTON, DC

Mr. REDDAWAY. Thank you, Senator.

As a political scientist, I've drafted my statement as a political analysis which will hopefully facilitate discussion of the issues. Attached to my statement are two recent articles of mine from the New York Times and the Boston Globe, which elaborate my views and which you may want to include in the record.

Senator BENNETT. We will indeed. Thank you.

Mr. REDDAWAY. I'd now like to summarize some of the main points in my statement.

In the last 2 months, a very significant set of shifts has begun taking place in the relationships between Russia, IMF and World Bank, and the west, meaning especially the United States. I believe that these shifts were delayed by the predictably unsuccessful attempts over 2 years to make the existing economic and political relationships work effectively. Now that the shifts are underway, I believe that there is a strong logic to them, and they will continue to unfold rather rapidly.

It seems unlikely that any new stability in the relationships will be achievable in the foreseeable future.

Last December, the Russian parliamentary elections resulted in 43 percent of the popular vote going to hardline, anti-western, anti-reformist parties. And 15 percent going to the one pro-government reformist party. A further 19 percent went to mildly reformist parties.

In response to this shock, the already weak Yeltsin administration decided in January—last month—that to have any chance of surviving in power, it must change course. It decided first to abandon its 2-year long effort to achieve macroeconomic stabilization through a major IMF assistance program. The consequence of this is that, as Professor Sachs and Professor Goldman have said, hyperinflation is likely now to develop fairly soon.

Second, the Yeltsin administration decided to try to guard against the danger of being overthrown by intensifying its preparations to rule in an authoritarian fashion.

And third, it decided to continue to make Russia's foreign policy more assertive and nationalistic if mainly in terms of rhetoric, so as to undercut the appeal of the super-nationalism of Mr. Zhirinovsky.

Now largely in response to these shifts by the Yeltsin administration, and in the wake of President Clinton's visit to Moscow, Kiev, and Minsk, the U.S. Government started making shifts of its own.

In late January and early February, it reportedly decided first to stop pressuring the IMF to relax the conditions placed on the IMF's aid to Russia.

Second, the government reportedly decided to stop playing Russian politics in risky and in fact counterproductive ways in its attempt to shore up the power of President Yeltsin.

Third, the government decided to modify its policy of encouraging Russia to maintain stability in its neighboring countries. Instead, the government decided to caution Russia to do this only with the full agreement of those countries' governments and in accordance with international norms.

Fourth, the government reportedly decided to become more positive toward the efforts of East European countries eventually to join NATO. Correspondingly, the government decided to become less sensitive to Russia's concerns about such a shift.

Now, as these U.S. shifts become clearly visible to the Russian government in the coming weeks, the Russian government will probably react with increasing criticism and recrimination against the United States and the west.

This process has already begun, and I would like to produce a few quotations for you.

Recently, the Russian Prime Minister announced his view that "the mechanistic transfer of methods of Western economies to Russian soil does more harm than good."

The First Deputy Prime Minister, Mr. Soskovets, then complained that international organizations were exerting political pressure on Russia, even though they had, as yet, provided "no tangible economic aid." "As soon as we start talking about price regulation," he continued, "voices can immediately be heard saying that

this is not a pro-market measure, and that neither the West nor the IMF will approve of it. But why should we use other people's minds in our own country?"

And Foreign Minister Andrei Kozyrev, when rejecting some Western criticism, warned tartly on January 27, that Russia "will not listen to (the West's) lessons and lectures."

But as long as President Yeltsin remains in power, I, myself, believe that a major break with the West will probably not occur. His government still wants whatever political and economic support it can obtain from the West.

Also, its more assertive foreign policy will, in my opinion, be more rhetorical than real. However, there will be a second effect of these shifts in American and Western policy. They will strengthen the already clear trend toward increasing political and economic instability in Russia, in my view.

In politics, Mr. Yeltsin and his pro-Western allies will henceforth be more vulnerable to attack from the hardline majority in parliament which will charge that Yeltsin's policies have now been shown to have failed.

They will say such things as, "We always said the West never really intended to help us. We always said that the West really just wanted to break up the Soviet Union and then weaken and break up Russia."

Unfortunately, in this situation, President Yeltsin's powers of government are showing distinct flaws. President Yeltsin has become increasingly erratic in his general behavior, saying one thing, especially to foreign leaders like President Clinton, but doing another. Disappearing from Moscow for days on end, failing to resolve urgent matters quickly, and ignoring others. He is widely thought to be suffering from depression, as well as excessive drinking and a heart problem.

In economics, hyperinflation I'm afraid is definitely now on the agenda, and I would like to quote one of the more worrying statistics from the last couple of weeks.

On January 24, Prime Minister Chernomyrdin's chief analyst said that to cover all the additional anticipated payments to various social groups and sectors of the economy, the government had just instructed the Central Bank to print 17 trillion rubles in the first quarter of 1994 instead of the previously envisaged 7 trillion. The chief analyst also calculated that the new emissions could raise the budget deficit for 1994 to 25 percent of GNP.

How long is Mr. Yeltsin likely to be in power, and what is he doing to try to shore up that power?

As I indicated, he is turning systematically toward a more authoritarian style of rule, trying to take all the main levers of power into his own hands. Thus, he has increased his control of television and two key news agencies. He has divided the state security organs into separate agencies, and subordinated them to his personal apparatus, and he's initiated plans to take similar action with the police and the military.

He has sharply trimmed the powers of parliament, has drafted a law to do likewise to the Constitutional Court, has purged the Council of Ministers and the Security Council of most of their re-

formers, has moved to increase the range of curbs on political parties, and has promoted conservatives in his own apparatus.

Politics in Moscow is becoming increasingly unstable. There is a danger of a new coup or attempted coups. Also, the country is gradually coming apart at the seams.

Let me quote some recent statements by Russian political leaders.

The Minister for Regional Policy, Mr. Shakhrai, sees the weakness of the ruble leading, in 1994, to regional conflicts involving economic separatism and resort to the primitivism of interregional barter.

The former Chief Executive of the Security Council, Yuri Skokov, agrees with the widespread view that economic reform and social policy will henceforth be determined by each region for itself. This is because, in his view, the Kremlin has neither the administrative levers nor the revenue to perform such functions.

The biggest danger, in my opinion, is that several years from now the forces that Mr. Zhirinovskiy has tapped will perhaps coalesce into an ultra-nationalist movement which may manage to come to power on the basis of a campaign to restore the unity of Russia and to reverse the humiliations of the Russian people.

In these circumstances, what aid is possible still from the West?

Let me just make a brief comment on this.

The aid least likely to be wasted or embezzled is investment in people. Teaching them skills that will be useful to Russia almost whatever regime is in power. Aid-givers should certainly in most cases bypass governments of all sorts to avoid the endemic corruption that pervades them, and they should try to identify groups and individuals at the grassroots of Russian society who are both promising in their endeavors and honest. They're not very easy to find.

Finally, I would like to comment on Mr. Simons' remarks about Poland and Russia.

I share Mr. Simons' optimism about Poland. But as I have argued consistently since 1991, Russia is not Poland. Russia is profoundly different in many very important ways.

Russia has a very different political culture which is much less suitable for radical economic reform in the short term. There has never been a strong consensus in Russia for radical economic reform, unlike in Poland.

Russia is not a country like Poland with ethnic homogeneity. It is a country with many and very complex national minorities, among whom nationalism is, in many cases, strong.

Finally, Russia is a country with strong imperial traditions, unlike Poland, and those imperial traditions unfortunately get in the way of a serious and sustained attempt at economic reform.

Thank you.

Senator BENNETT. Thank you very much.

Now, Mr. Wanniski, you get to be the cleanup hitter of this set.

**STATEMENT OF JUDE T. WANNISKI, PRESIDENT,
POLYCONOMICS, INC., MORRISTOWN, NJ**

Mr. WANNISKI. Thank you, Mr. Chairman. And thank you for inviting me to these important hearings.

I've written a very long statement, kind of a supply side analysis of the last several years, I will submit for the record.

I'll just read the introduction here, a bit of it, and then summarize the rest.

It should be no surprise that great controversy surrounds the economic policies followed by the governments in Moscow during the past 5 years.

How does one convert a command economy of significant size and complexity to a market economy?

In all of history, never before has this problem of political economics confronted the global experts. There is nothing in the textbooks to suggest how it might be done.

My study of the problem began in early 1989 when the Soviet Embassy in Washington, DC, asked my opinion of how the conversion could be accomplished. My interest is also tied to the fact that my father's parents came here from Poland and the Ukraine, my mother's from Lithuania.

In the 5 years since, I've made several trips to Moscow at the invitation of the Gorbachev and Yeltsin governments. I've also had several dozen meetings with representatives of the Soviet and succeeding Russian government, in Washington and New York, to discuss this central issue.

For a brief period in early 1992, I was an official advisor to the Yeltsin finance ministry under an agreement signed by Yegor Gaidar. All, I might add, pro bono.

Here, briefly, is how I saw the central problem, which has two parts, then and now.

First, in a command economy, wages, prices, and capital allocation are dictated by a committee of experts who process information flows through state channels. In a market economy, these are determined through market mechanisms which have evolved to process vastly greater information flows through private channels.

The question: How should these mechanisms be created in a country starting from scratch? And at what pace and in what sequence?

I might say that if you put a bunch of economists in a room and ask them to write the ten things down that should be done to convert a communist system into a capitalist system, they'd essentially write the same ten things. The difference would be in the sequence. What do you do first, what do you do second, what do you do ninth and tenth.

That's been the basic disagreement between the shock therapists and some others of us.

Second, I would ask the second most important question: In a communist society, almost all capital is in the possession of the state. In a capitalist society, almost all capital is possessed by individuals. In converting from the former to the latter, by what method should the state transfer most of the capital to its citizens?

Could this method be financed by the state through cash flow? Or should the conversion be treated as a one-time capital expense, as if a war were occurring, one time, to be financed by an increase in the public debt through bond finance?

Now, unfortunately, these questions were not even remotely asked in the way I have posed them. By its very nature, shock

therapy, as it has come to be called, involved an indiscriminate leap from one system to another.

Last September, when I was in Beijing at the invitation of the People's Bank of China, I asked the deputy director of the bank reform department, Mrs. Wu Xiaoling, what she thought of the situation in Russia. She shook her head sadly and said, through a translator, you do not burn down the old house before you build a new one.

Now the questions you raised earlier, Mr. Chairman, about capital I think are central here to what's gone wrong in the last 5 years, and to think of how different Poland is from Russia and some of the other communist countries.

In the United States, for example, I would venture that 95 percent of all the capital, all the wealth in this country is possessed by individuals.

In Russia 5 years ago, 95 percent of all the wealth was owned by the state. The only 5 percent of the wealth owned by individuals were the clothes on their backs and the deposits of savings, the 600 billion rubles, the so-called overhang which they held in state depositories.

In Poland, as Marshall Goldman indicated, communism hadn't collectivized everything in the state. Most of the farms, 80 percent of them, were still owned by individuals. A lot of private housing was owned by individuals.

The same was true in Weimar, Germany where, after the inflation, people could at least collateralize the equity in their businesses, their industries, their homes and their farms, to start anew.

In 1989, when I first went to Moscow, I asked the Russians to consider that the only comparable situation that I could think of in history was in 1865 at the end of the Civil War, where the black free men of the south were turned loose without any capital. There was no money capital, they had no businesses, they had no farms. At least the white southerners of old Dixie could collateralize equity on their businesses, their farms, and their homes, to start from scratch.

Here was a situation. If this 600 billion rubles in overhang were wiped out, there would be no capital. All of the capital in the eleven time zones of the Soviet Union would be in the possession of the state.

So the first thing you have to do is recommit to your citizens that you will not wipe away the purchasing power of that 600 billion rubles. In fact, you should restore the purchasing power by a monetary deflation which is possible here in your country.

The arguments I had to cut against were those of the shock therapists at the IMF, the World Bank, and the Treasury Department of the Bush administration. Which argued that the first thing you should do in the sequence is lift wages and prices. And the push began from these institutions to raise the price of oil, in particular, which is a primary import in industry and agriculture, as you know, all fertilizer being petroleum based.

Let me give you just some of the numbers that we're talking about here, because they're really frightening to see what's happened.

In 1990, under the price control system, it took 120 rubles to buy a metric ton of petroleum. At the time, Russia, the Soviet Union was the greatest producer of petroleum in the world, 12 million barrels a day.

Now finally the price of oil in Russia at the time was the equivalent of \$4 a barrel, one-fifth of the world price level. And the pressure from the IMF and World Bank said get these prices to the world price level so that, according to the economic textbooks, you'll then be in equilibrium in the world markets.

The Gorbachev government relented, at least to the extent of increasing the price of oil by 60 percent, 200 rubles a metric ton from 120.

If industry and agriculture had to pay a 60 percent increase, they couldn't afford to; they would have to shut down. So they turned to the Central Bank, run by Viktor Geraschenko and controlled by the parliament, and he issued the credits to enable industry and agriculture to buy petroleum.

Well this outraged the IMF/World Bank people. They said that this is going against our plans for you, and obviously you have to accept a high degree of unemployment to get through this process. And the push began again to raise the price of petroleum.

The fact that the government controlled the oil price and the parliament controlled the Central Bank led to a ratcheting up of the inflation rate to the point where last December the price of oil in rubles was 25,000 rubles a metric ton. That's at the time when the Yeltsin government blew up the parliament. The people in the parliament that were blown up, by the way, were objecting to this method of bringing Russia into a market economy.

Since the parliament was blown up, the ruble price of oil was pushed again to 50,000; it's now 50,000 rubles per metric ton.

IMF and the World Bank and our U.S. Treasury Department, Dr. Summers, as we sit here, are still insisting that they push the price of oil to the world price level, and since the price of oil at 50,000 rubles is still \$4 a barrel, it would have to go to something on the order of a quarter of a trillion rubles a metric ton.

Now I feel some encouragement now that in the elections of December, the people of Russia have said enough is enough. We're not going to do this anymore. And that Yegor Gaidar and Boris Fyodorov, who are the authors, along with IMF/World Bank of this scheme, have now been pitched out, and Prime Minister Chernomyrdin has announced that they are no longer going to use these methods to convert to a market economy, and they're not going to use shedding off credits from the Central Bank to industry in order to stop the inflation. They're going to use price controls.

This is the correct answer. Price controls should be used until a new house is built. Price controls, wage controls, and capital allocation were the methods by which the Soviet people operated for 75 years, to go to a new system, do it the way the Chinese did it.

The Chinese, over the last 15 years, built a new system on top of the old system. Fifteen years ago, the per capita GNP in China was \$200 equivalent. It is now on the order of \$3,600 equivalent.

The Chinese 2 years ago, 1992, were still selling petroleum to their domestic farmers and industries at the equivalent of \$3 a barrel over all of these years. They finally now, because they're getting

so rich, can afford to move the oil price to the world market level and the price of oil in China is now \$11 a barrel.

This equates with roughly \$17, \$18 in the West. They still haven't gotten there but they're doing it. It's not only gradual, but they're doing it in a way and at a pace and at a sequence that enables the people to operate around a unitive account, a currency that's held its value through all these times.

The difference between China and Russia is not that the people of China have been an agricultural country and Russia an industrial one; almost all the people in both countries have been involved in agriculture, as Dr. Summers' own statement indicates.

The difference is that when Deng Xiaoping decided to convert to a market economy, he did not turn to the western economists of the IMF/World Bank and U.S. Treasury Department. He turned to the Chinese diaspora in Hong Kong and Singapore, the financiers there, and asked them how do we do it. And they said, keep your tax base low, keep your currency sound, and keep regulation at a minimum, which is what they're doing. This is the policies in Hong Kong and Singapore. So China is growing, the fastest growing economy in the world, and it violated all of the prescriptions and rules and scenarios of the International Financial Institutions to the point where it's almost frightening us in the West considering how 1.2 billion people might multiply again and again and again into the 21st Century on these policies.

I'm encouraged, though, by the elections of last December. I'm encouraged by the statements coming out of Moscow, Prime Minister Chernomyrdin, and I'm encouraged that the new Economics Minister, Alexander Shokhin, has spent the last 18 months traveling back and forth to Beijing.

Where the people of Moscow, the governments in Moscow have now given up on advice from the West, they're turning to the East for guidance. And I think, as they find it, we will see the stabilization of the ruble occur and a transfer of capital from the state to the citizenry occur at a faster pace than could possibly accomplish with the shock therapy that has been gone on to date.

The one recommendation that I would make, and I have made this to Ambassador Lukhin before the elections in December when I met with him at the embassy here in Washington, was that they reverse the process. That it's far easier, at 50,000 rubles per metric ton, you're going to have a lot of inflation. A lot of credits have to be issued. Roll it back to 25,000. It would be a huge, 50 percent tax cut on all industry and agriculture.

And once you saw how the ruble would strengthen as a result of going in the reverse direction, you could cut the price again to maybe 10,000 rubles a metric ton. And then instead of talking about financing all of this with balanced budgets, it's crazy to convert, to talk about balanced budgets in a new born economy.

The state has all the wealth of eleven time zones and could easily afford huge budget deficits which are one way of transferring capital from the state to individual hands.

The only way you can do that is through bond finance. And I had recommended, year after year, that the government of Moscow, the Central Bank consider a bond issue of 10-year maturity where the bonds would increase in value year after year after year, as you got

to the maturity, so that people would get a capital gain for betting on the government in year one.

You could then issue great amounts of debt, I argued, and these bonds would be snapped up by the people of Russia because they could see, instead of going in the direction of shock therapy and inflation, they would go the reverse route to stabilization and the restoration of the value of assets in individual hands.

I don't know if that route is going to be taken, or is even being considered in Moscow. I haven't had much direct contact with the government there for a long while, but I would say that if any of these simple steps were taken, we would see progress instantly.

Senator BENNETT. Mr. Wanniski, you used a word that no one else on the panel has used; you're encouraged. Everyone else on the panel took a different tack.

Professor Goldman, I think you started out as the pessimist.

Perhaps the best thing, from my point of view, would be to simply let you four begin to respond back and forth across this, because I'm sure you would have a more cogent series of questions of Mr. Wanniski than I would have, and I'm sure the other two are not shrinking violets and would love to step in with comments.

You're at that end and he's at this end, and you were the pessimist and he's the one that's encouraged, I'd ask you if you would, to respond.

Mr. GOLDMAN. Well, I'm delighted that somebody is encouraged looking at this, because the closer you get, the less encouraged I tend to be for sure.

I also think there is the possibility that we'll pull back to more government controls. There could be some move toward creating those institutions that I think ultimately are necessary. And as Peter Reddaway mentioned, the parliament, which has been elected, whatever the extenuating circumstances there might be, has been elected with the idea that not only the nationalists, the liberal democratic party, but also the communists are opposed to many of the things that were being done. A substantial portion of the population are not eager to see a continuation of the reform process, or the creation of new businesses.

They say they're in favor, they say they support reform but again it's a very different kind of reform and not very different from what was being done before.

But let me just try to meet Mr. Wanniski head on in one particular point.

I have difficulty understanding what he meant by reducing the price of oil. I can understand his concern that raising the price of oil to world prices would cause a great shock. That's why I suggested there be a currency reform before any price liberalization.

But the difficulty, and one of the reasons why there is such chaos and such confusion, and one of the reasons why oil production is dropping is that because oil prices in Russia right now don't meet the cost of production that is in part due to the inflation. So it's a chicken and an egg thing, but there it is. People don't pay oil producers for producing so the oil producers are actually operating at a loss, which is bizarre.

In addition, (and this is probably the most serious thing) we've got a world oil price that's four times higher than the Russian do-

mestic price. Thus there's an enormous temptation to smuggle the oil outside of the country.

That leads to enormous pressure to get permits to export, which are then sold, this leads to corruption flowing all over the place. The Mafia has involved itself and this has led to a general breakdown.

I also had difficulty understanding when he said there'll be a return to wage control and price controls and that he sees this as a liberalization. In the case of China, for example, I have a different version of the sequence that took place there.

My understanding, and I've spent a lot of time looking at China, is that the reforms began in December 1978, began in 1979. The Chinese, even the overseas Chinese were not really much involved until 1983, 1984, 1985. Deng Xiaoping just let it happen. And I see a contradiction here. On the one hand, he wants price controls and wage controls. On the other hand, he says you really want to keep the government hand on.

I do see in Russia, and I'll just stop here, I do see in Russia an increase in government controls but I don't see the liberalization that I would like to see in the creation of new institutions, and that's why I'm pessimistic. And if you really want to be pessimistic then you have to look at the other portion of my statement which says I also see the re-creation of the former Soviet Union, at least in part. And already we're seeing very anti-western statements coming out. So economically, politically, sociologically, it's really quite scary.

Senator BENNETT. Let me ask this question of whoever wants to respond.

The first panel made it very clear they saw no parallel whatsoever between Russia and China. Mr. Wanniski has raised that issue. The first panel was leaning heavily on the parallel between Russia and Poland. As I listen to this panel, I got the feeling there was less agreement on the parallel between Russia and Poland here than there is on the part of the administration.

I ask the question now of the other panelists, how much agreement is there on the issue raised by Mr. Wanniski that there can be a degree of parallelism between Russia and China?

Mr. Sachs.

Mr. SACHS. Let me start with one point on the inflation. The Russia inflation process shows a very close link between the amount of rubles that are printed and the subsequent inflation rate. In this sense, Russia is like just about any other economy you've ever seen. And I think this is important to understand.

Russian prices are rising at between 10 and 20 percent a month right now because that's the rate of increase of the Russian money supply and the links have been quite close. In months or periods, quarters when the money supply grew at 30 or 35 percent per month, 3 or 4 months down the road, you found similar rates of increase of prices. And the money supply growth was restricted to around 10 percent a month, which isn't very restrictive but it still better.

Then you found that inflation tended to fall, as it did in the end of 1993. So in this sense, I don't really think we have to become too metaphysical on the point. There's a certain rather identifiable

relationship and one that has been pretty good for hundreds of countries for the three centuries since David Hume first discovered the relationship, and I think it's a good starting point.

So the question operationally in ending the inflation is how to reduce the rapid growth of the money supply.

And there you look mechanically. Where does the money supply come from? It is credit that goes to the budget deficit because in Russia, you pay for the budget deficit right now not by issuing bonds but by printing money.

Second, it's credit to industry via the so-called commercial banks which are basically still state banks.

So you have to restrict, and it used to be, as of last year, and probably will be again in 1994—I'm sorry, it was in 1992 and it will be again probably in 1994 credit that was issued for the neighboring states as part of Russia's I think misguided foreign policy of giving huge amounts of, in essence, foreign aid to a point that it contributes to their remarkable inflation. What do you do about it?

Well, I think one thing that Mr. Wanniski said I would agree with, and that is that part of the answer is that you try to finance the government, not by just borrowing from the Central Bank, but by issuing bonds.

And I also agree with him that that would be possible in an overall coherent framework. It's not possible in a mass to get people to buy the bonds, but if there were an overall stabilization framework, then I think there is a case to be made that this would be a way to go. And I believe that the IMF has very much down-pedaled that, rather focusing all its attention just on cutting the deficit. So there's an area of agreement there.

Quantitatively, we'd have to look at how much can be done, but I think that is a piece. And I believe very much that foreign assistance is another piece of how to finance the budget deficit, the one that we promised but didn't deliver. That's another piece of how to do this in a non-inflationary way. And I think, from an operational point of view, that is the most urgent question, is this high inflation.

Again, if it were a stable environment and it were really a question, do you want to make a market economy in 2 years or 5 years, we wouldn't be so agitated about it. It's rather the sense that the place has deeply destabilized. Weimar 1923 I think is a workable analogy. It's so deeply destabilized that we feel that this great instability can translate into much greater dangers.

The philosophy of precisely how to make the market economy, whether it's going to take 2 years or 5 years or 10 years, I think, per se, is less interesting. We could discuss it, but I don't think that that's exactly why we're here. We're trying to head off great instability, not figure out how to save 6 months on making a market economy.

In my own view, on the latter question about making a market economy, I think that there are enough differences with China that unfortunately one can't rely on the Chinese case, and for one simple reason. The Chinese haven't figured out what to do with their own state enterprises.

They were able to do one thing. Since they had 80 percent of the population outside state enterprise, and only 20 percent of the workers in state enterprise, they basically had a peasant economy, with only 20 percent in state enterprises. They were able to keep subsidizing these state enterprises, let the other people have economic freedom to do their thing, and it's been wonderful. It's been one of the most remarkable economic successes in history to be sure.

But Russia doesn't have that luxury to just let its state enterprises be because 95 percent of the workers are in the state enterprise system with all its failings; huge subsidies, guarantees that can't be met, social guarantees that are beyond the cost of the budget and so forth. So it doesn't have this two-track potential that China had, which was to not handle the hardest part politically, just let it be continue pumping out the subsidies but let the other 80 percent of the population have their economic freedom, which was the real source of the gains in China.

I wish Russia had that capacity. Unfortunately, they started with a bankrupt system where everyone was in the state sector, not just the urban industrial workers, as in China. They didn't have 80 percent in peasantry except back in 1910, which Marshall Goldman mentioned, but not today.

And finally, I think, you know, this game of metaphors is really too much, but I can't resist saying that it's wonderful advice not to burn down a house before you build a new one. And that's what I would have told to Russian reformers a long time ago. Make sure you're building your new house.

It's very different advice when you find yourself in a burning house. What do you do? And that, I want to stress, is already what the situation was in 1992. The idea that someone took a torch to the old system because they didn't like it is a mind-bogglingly wrong idea of what the situation was.

The Soviet Union collapsed and it collapsed because of financial bankruptcy, moral bankruptcy, political bankruptcy, economic collapse, and it already was collapsed before you ever heard the name Yegor Gaidar, I must stress again. Already they were on the brink of hyperinflation, so things had to be done. It wasn't a choice about a burning house. You found yourself in a burning house, and you had to do something to try to get out.

And I think that that's the main difference that I would have with that metaphor.

Senator BENNETT. Thank you.

Did you want to comment, Mr. Reddaway?

Mr. REDDAWAY. If I could, briefly.

I think in comparison with the Chinese, the Russians are at certain rather important disadvantages. If you consider the overall political and economic culture of the two countries, Russia has the disadvantage that it spent 74 years under communism, which destroyed the sort of political and economic culture that is needed for radical economic marketizing reform. Whereas the Chinese have only labored under communism for 44 years, and that's a very important difference which affects your human capital.

The second point would be the Chinese have been stimulated, particularly over the last nearly 20 years, by the effects and inputs

of the overseas Chinese into their economy from Hong Kong, Singapore, and elsewhere, in ways that the Russians have not been stimulated by overseas Russians.

Also, the Chinese government still has some control, if a declining level of control, over the country, over China. They still have a more or less stable administrative and political framework, they still have more or less functioning organs of law and order.

The Russian government no longer has control over most of the country. They no longer have a stable, administrative framework. They no longer have effectively functioning organs of law and order.

And that leads me into a final comment in response to Mr. Wanniski about the desirability, and he thinks the achievability of restoring price and wage controls under the present government of Mr. Chernomyrdin.

I think that approach might perhaps, even despite Mr. Sachs' image of the burning house, might conceivably have worked 2 or 3 years ago. But I'm quite sure myself that it is not going to work now, however hard Mr. Chernomyrdin and others try.

The ministries which Mr. Chernomyrdin will be forced to rely on have lost their previous power over the regions and republics that make up Russia. That administrative and political power has simply vanished, to a very large extent, from Moscow into the regions or republics, along with the breakdown of law and order.

The police, the security forces and the military in Russia are deeply divided today and deeply demoralized. They're not in a position to enforce the restoration of power on behalf of the central government. And that is my most fundamental reason for being pessimistic about the short-term future, in that the authority of the state has collapsed in Russia. And it cannot possibly, in my opinion, be restored in the near future, over the next few years, because the Russian people are so very deeply divided among themselves about what political and economic values they hold, what they subscribe to.

The parliament, the present parliament is a very good reflection of that. And until you manage to re-create some authority of the state, you are not going to have a basis on which to move forward in a purposeful way with economic reform.

Senator BENNETT. Thank you.

We're coming to the point where we need to wind it up. And Chairman Riegle has left a question for Mr. Wanniski with the request that all of the others comment. So this probably is as good a way as any to bring this to a close.

Mr. Wanniski, in his prepared testimony, Professor Sachs contends that the IMF's insistence on Russia cutting its budget deficit has been misplaced. Such cuts, he contends, are economically and politically unjustified. Instead, he calls for shifting the financing of the budget deficit from monetary financing, which leads to inflation, to foreign financing and domestic bond financing. Do you think his recommendations are correct? And if not, why not?

We may have touched on this, but the Chairman wants the focus on it.

Mr. WANNISKI. This is the essence of my recommendation to the Gorbachev government and the Yeltsin government over the last 5

years, that there be a strategy that would be designed to restore the confidence of the people in the government.

That's really what the problem of public finance that we have now in Russia is that the people do not trust the government not to cheat them as the government has been cheating them for 75 years. If the government would issue bonds that would increase in value over a 10-year time, and pledge, through a ruble stabilization fund backed by the West, so the people would see that if they're going to get cheated, the Westerners are going to get cheated, that they will have more confidence in buying those instruments.

This is essentially what Alexander Hamilton did. I think Professor Summers doesn't quite understand how Alexander Hamilton got this country started.

I went through this discussion with Yegor Gaidar in December 1991, telling him that no country has started out by declaring bankruptcy and been successful. And this is what the IMF/World Bank is suggesting that you do.

In 1791, Alexander Hamilton found a dollar overhang from the Revolutionary War, where U.S. debt was trading at 15 cents on the dollar. And the recommendation was made, get rid of this ruble overhang, this dollar overhang, and let's start fresh.

And he said no, we are going to pay all our bills at par. And when the debt was trading at 15 cents on the dollar, he said we're going to pay it out of the vast resources of this new country when we can. He negotiated with our bankers in Holland to extend the maturity of the debt at low interest rates, and he promised to pay it in gold, even though we didn't have any gold, except in the ground. And within a year or two, the debt of the United States was trading at \$1.15 instead of fifteen cents. We were off and away.

We would do the same thing if we recommended this model, recommend the model of the United States in 1791, not 1994, to the people of that part of the world.

Senator BENNETT. The Chairman has asked each to comment, and I'm sure you're anxious to.

Professor Goldman, we'll start with you.

We'll save you until last, Professor Sachs, since your name was used in the question.

Mr. GOLDMAN. And I suspect no one is going to oppose it, but I would begin by saying I support the idea of bond financing but then I will back away very quickly.

I worry about providing funds at a time when the system is broken down, when there's distrust and when it's much easier and safer to put your money in dollars, as you said earlier in the beginning of your statement and your questioning of Mr. Summers.

And in particular it is necessary to prevent funds from flowing out to Swiss banks, either in the form of oil exports or commodity goods, or just simply taking it out in cash.

There was an article, over the weekend, in the London Financial Times describing how Russians are now buying up property in London, as a consequence of this capital outflow process. And I think the last thing we want to have is somebody saying that the United States taxpayer is financing Russians buying property in foreign countries.

I'm myself would prefer a focusing on private aid, private project financing, specifically institutional creation. I do think if we make a political decision, and it seems to me it is a political decision, that we want to buy time by helping Russians over this long period, and I think it's going to be a long period, while they try to work out their system and what they want out of life.

If we're going to turn to international institutions, we should create a brand new international institution just like the International Finance Corporation. If we create special favoritism for Russia in regard to the IMF, then the IMF's purposes are lost when we come to Africa, Latin America or Asia. And I would hate to see that. It has a useful purpose other than that.

So I would say, create the special institution. I know that's another bureaucracy. Give them a mandate. Go ahead, your function is to create stability in Russia. We give you four decades in which to do it, but don't hold your breath.

Senator BENNETT. Mr. Reddaway.

Mr. REDDAWAY. I'll yield my time to Mr. Sachs.

Senator BENNETT. Thank you.

Professor Sachs.

Mr. SACHS. I can't help but also going back to 1791 just to add one thing. We didn't quite pay it back at par as I think Jude Wanniski knows, because one thing that Hamilton did was demand in fact that the creditors cut the interest rate from 6 percent to 4 percent on a substantial part of the debt.

And that was fine because foreign assistance, in that form, with the Paris Club in fact, most of the debt was circulating in Paris, was needed for us to get a fresh start at that point.

I think the history or reform has always been strong measures of currency stabilization inside matched by external help, whether it's a reduction of the debt burden, rescheduling Poland's debt cancellation, Marshall Plan, and so forth.

I believe we have not put that package together, so far, and I think that what this point about how to do it is a principal point, it's not simply that we demand our conditions and the conditions are a zero budget deficit or we won't lend.

That's I think a point many of us probably would share. At least two people on the panel think that that has not been the best way. I do have to caution, though, that there are limits in the other way also.

The money is being printed because there was reckless and rampant spending. Unlike 1791, when our taxes were probably, I don't know, I'd guess 3 percent of GNP, and our government spending was something like that, although I'll correct the record when I find out the exact number, in Russia you have the state that is a part of everything, and therefore a bankrupt state is a much larger financial problem.

And one does have to really cut a great deal of the wasteful subsidies and that's politically and socially very painful, which is a reason why we have to help.

The amount of adjustment that Russia would have to do to get within this feasible band that they could actually sell government bonds with some confidence and we could back their currency is a lot of adjustment.

But I don't believe that we've met them part of the way so far, and I think that that's the gist of my testimony and where I agree, and it's only in that area, I have to ask with Mr. Wanniski, I don't think the return to wage price controls or the return to the burning house or the return to many other things are right, but I do believe that there is absolute importance in stabilization and giving confidence in the currency. I think that's the starting point.

It's been the starting point of every reform I've been involved in, and I've seen it work, with my own eyes, what seemed like miracles on the ground, when you have a currency that holds its value and can be used for real business.

And that's why countries like Poland, Estonia, Slovenia, the Czech Republic, are turning around right now. I don't think it is this great mystery that, well, Russia's different so it can't learn. The need for a stable money is as much true in Russia as it is in any of these other places. And the way to get at it, I think, is fundamentally the same.

It does require our help. It does require a different strategy of the International Monetary Fund. And it requires much more involvement of the U.S. administration and the G-7 in leading the process to get us there.

Because this isn't an ex post complaint about the IMF, this has been a problem that's been going on for at least a couple of years.

I think the criteria have been wrong, the nature of the negotiations has been largely wrong, the unwillingness to provide real aid is the thing that does lead to the anti-Western backlash, that we have made statements about large-scale aid that never came.

That's what the Russians are going to remember. They're not going to remember the fine point that it was this or that kind of—of conditionality which happened not to be appropriate conditionality in many ways; what they're going to remember is that the aid wasn't there.

So we had to work, we should have worked much harder in the last 2 years to deliver, and that would have involved being in Moscow much more at the most senior levels and hashing this out and discussing this. And it would have involved a somewhat different financial approach; not totally, but somewhat different, which would have put the first focus on getting a stable currency and a ruble stabilization fund.

This is something, as their advisor, that I begged for 2 years, that Gaidar asked for right at the very beginning, that the IMF has held off the table to this moment, hasn't even had one serious discussion with the Russian government in 2 years about this because it's internal policy was to say that the stabilization fund will come at the end of the process, not at the beginning of the process.

This has been a huge tactical mistake. And it's these kinds of technical issues and tactical issues that really do have to be explored, rather than the hand-waving that they believe in tough conditions and everyone else wants easy conditions. That's really not what's at stake here.

Mr. WANNISKI. Can I just?

Senator BENNETT. All right.

Mr. WANNISKI. There has been, I think, some misunderstanding where the people on the panel saying I'm advocating a return to

wage and price controls. There are wage and price controls now. I mean, one of the things I say I'm encouraged about is that Chernomyrdin has indicated he's not going to allow the price of oil to go up further, from 50,000 rubles a metric ton, which is one-fourth or one-fifth of the world price level.

It's also something that I'd like the panel to consider because it seems that so many people I talk to about the conversion process in Russia forget that where you have controls in the United States, price controls, if the Government of the United States tells our petroleum industry that they can't charge more than X, they're essentially stealing from the petroleum industry. They're confiscating wealth.

In Russia, the state owns all these commodities. They own most of the whole country. So for them to sell oil at one-fifth of the world price is the equivalent, say, of Abraham Lincoln in 1865 giving the slaves 40 acres and a mule. It's a transfer of wealth from the state to the people and this is all we're talking about. How do you do it?

Mr. GOLDMAN. I just have to say I think Mr. Wanniski's wrong. I don't know where he got this from. There are no wage controls in place now, there are no price controls except for a very few products. What he's talking about is reintroducing it, and it's bewildering to me, I must confess, and I just have to say that.

Senator BENNETT. OK.

We apologize for holding you so late, but on behalf of the committee, may I thank you for coming and for the exchange and for the effort, intellectual and otherwise, that went into this.

This committee has no immediate control over any of these things. We don't control appropriations or authorizations for any of these agencies but in the world of congressional assignment, we do have an oversight responsibility for policy in this area.

I think the presentations that we've had here today have been very useful with the first panel telling us where the administration is, and the conviction that we just need to stay the course and everything will somehow come out all right, and the second panel, whatever your disagreements among yourselves, as a group, laying out very clearly that there are legitimate challenges to the administration's course and that people of good will can disagree.

I think the exchange as a whole has been an extremely useful one, and the record that has been created will be very useful.

For me personally and, again, on behalf of the committee I thank you very much for coming.

The hearing is adjourned.

[Whereupon, at 4:45 p.m., Tuesday, February 8, 1994, the committee was adjourned, subject to the call of the chair.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF LAWRENCE H. SUMMERS
 UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, U.S. TREASURY DEPARTMENT
 RUSSIAN REFORM AT A CRITICAL JUNCTURE: THE ROLE OF WESTERN SUPPORT

INTRODUCTION

Thank you Chairman Riegle and Members of the Committee. It is a great pleasure to testify on the multilateral support strategy for market reform in Russia.

The touchstone of our policy toward Russia is that we support democratization and the creation of a market economy. That policy is grounded in our own self interest. A prosperous Russia is less likely to be an insecure, expansionist Russia. And, there is even some prospect that the integration of Russia—with its ample natural and human resources—into the world economy could provide a global engine of growth that would benefit the next generation of Americans.

President Clinton's first major foreign policy initiative was to call for deepening our engagement in support of Russian reform. From the beginning, we have acknowledged two important realities.

- First, Russia must choose its own future and take responsibility for charting the political and economic course to achieve its goals. Western support can help Russia achieve those goals, but we cannot determine the outcome of events.
- Secondly, Russia's progress down the path to a market economy will inevitably proceed in fits and starts. Western support must make allowance for this reality, so that we can stand with Russia over the long haul. That is why our approach provides a steady inducement to reform, backed up with reinforcement for steps in the right direction.

THE SUPPORT STRATEGY

Let me begin by explaining our two-track support strategy. First, *core support* aims at promoting the "bottom up" changes across the breadth of Russia that will make reform irreversible. Secondly, *conditional support* aims at reinforcing the "top down" tasks of stabilization and structural reform that must be carried out at the center.

Our *core support* for Russia is intended to strengthen the base for democracy and a market economy. We do this through our bilateral assistance programs, funded by the \$4.1 billion for Russia and the other nations of the former Soviet Union that the President announced last year. The \$1.6 billion Vancouver package is fully obligated and about 70 percent disbursed. The \$2.5 billion Tokyo package, approved by the Congress in September 1993, will be spent in 1994 and 1995. Technical assistance, support for private sector development, and educational exchanges have played an essential role throughout Eastern Europe and the FSU in helping build the institutional foundation of a market economy and in promoting democratization. Core support is not conditioned upon particular reform steps, rather its aim is to improve the conditions for reform.

But Russia's transformation also requires *conditional support* in the form of loans from the International Financial Institutions (IFI's) to support stabilization and structural reform. Support from the IFI's is conditioned on concrete steps toward reform, both to encourage those very steps and to ensure the effective use of western resources.

This approach guided the G-7 Foreign and Finance Ministers in Tokyo last April, when they developed a multilateral support program to provide up to \$28 billion over the 14 month period through the 1994 Naples Summit, depending upon the pace of reform in Russia (see attachment). That program included loans from the IMF, World Bank, EBRD, and bilateral export credit agencies.

The package was designed to reinforce early reform steps. If you will, we wanted to support each step up the ladder of reform, rather than hold support back until Russia scaled the entire wall. The key design innovation was the creation by the IMF of the Systemic Transformation Facility (STF), a facility designed to encourage Russia and other economies in transition to begin undertaking reform measures that would lead to full stabilization.

To strengthen further our support for structural reforms, the G-7 Heads of State agreed at the Tokyo Economic Summit in July to create a Special Privatization and Restructuring Program (SPRP), in cooperation with international financial institutions, to assist in the modernization of large Russian firms. This program will mobilize \$3 billion and focuses on an initial period through 1994. The SPRP will provide equity, loans, and export credit support for enterprise restructuring. A network of equity funds is being established to make investments in Russian firms. Another important component of the SPRP is a \$500 million Social Safety Net Adjustment

Loan being developed by the World Bank to help alleviate social burdens that result from the restructuring of Russian firms.

The United States is participating directly in the SPRP by contributing \$125 million in bilateral grant support out of last September's \$2.5 billion support package for Russia and the FSU. The bulk of this grant, \$100 million, will go to create a Fund for Large Enterprise Restructuring (FLER). The FLER is now taking shape and it will be headed by Michael Blumenthal, who was Secretary of the Treasury in the late 1970s. The United States has also pledged a further \$250 million in export credits to allow privatized companies to buy capital goods imports from the United States.

Western governments also provided \$15 billion in debt relief last year by rescheduling Russian debt service. Secretary Bentsen and then Russian Finance Minister Fedorov signed a bilateral agreement in September, and as a result, Russia, after paying \$450 million in arrears in the fourth quarter of last year, became current on its debts to the United States.

Finally, the G-7 created a Support Implementation Group (SIG) to improve the effectiveness of western support for Russian reform. The SIG grew out of a conversation between President Clinton and President Yeltsin at the April 1993 Vancouver Summit, when they agreed on the need for a body that would work to overcome bottlenecks in the disbursement of bilateral and multilateral support on both the Russian and Western sides. The SIG initiated its activities last September, and its work is now being intensified under the leadership of its U.S. Director, Michael Gillette.

ECONOMIC REFORM IN RUSSIA AND WESTERN SUPPORT

Let me now turn to economic reform developments in Russia and the progress that we have made in providing western support.

The dramatic political events and the unevenness of economic reform that we have witnessed in Russia have had the effect of obscuring an impressive record of reform over the past two years. The Russians have recorded impressive achievements in the areas of liberalization and privatization, and some progress in the all important area of stabilization. We should begin by reviewing and acknowledging this record, remembering that few thought these changes possible as the Soviet Union was falling apart not too long ago.

- The liberalization of prices and economic activity initiated by former Deputy Prime Minister Yegor Gaidar eliminated the long queues that had plagued the Russian people for decades. Academic studies suggest the cost in wasted time of long queues was on the order of 5 percent of national income in 1985. Now, goods are widely available throughout Russia; a new retail sector is emerging; and consumers have more choice in the purchases they make. While overall industrial production is falling, consumption of such durables as TVs, refrigerators, washing machines, and dryers is rising sharply.
- The privatization program carried out by Deputy Prime Minister Anatoly Chubais, who remains in Government, has been nothing short of remarkable. According to Russian data, this program has turned over to the Russian people 70 percent of all small scale shops and 7,000 large firms accounting for more than one-third of the industrial labor force. As a result, the difficult decisions of how to modernize Russia's companies rest in private hands. The privatization effort, which relies in large part on the use of vouchers given to each Russian citizen to purchase shares in private firms, commands wide public support. The price of vouchers, which had sunk to 4,000 rubles in early April 1993, rose to 25,000 rubles before Russia's elections.
- The unresolved problem of stabilization remains central to Russia's transformation, but during the tenure of Deputy Prime Minister Fedorov a base was laid for successful stabilization. By cutting costly subsidies, the fiscal deficit, which was about 20 percent of GDP in 1991, was brought down to about 10 percent of GDP by the fourth quarter of last year. Also, interest rates were raised sharply and credits to industry scaled back.

Our multilateral support for these reforms has produced some progress, but we have also faced difficult problems. On the positive side:

- Russia drew \$1.5 billion from the IMF STF last summer and many of the critical reforms undertaken last year were taken in conjunction with this loan.
- The World Bank fully obligated \$500 million under an import rehabilitation loan. And it has also approved a \$610 million loan to rehabilitate Russian oil wells. Oil rehabilitation loans are highly-cost effective, with estimates suggesting that a dollar invested in well rehabilitation will generate eighty cents in foreign exchange within a period of months.

- Export credit agencies have provided roughly \$4 billion in credits and guarantees to Russia. In this regard, the World Bank's recent decision—taken at U.S. urging—to provide a limited waiver of its negative pledge clause will allow the U.S. Export-Import Bank to move forward with up to \$2 billion in lending for Russia's oil and gas sector. This will create thousands of jobs at home and in Russia.

At the same time, the first steps toward stabilization which garnered initial IMF support did not lead, as we had hoped, to a full stabilization program. As a result, the second \$1.5 billion IMF STF loan remains under discussion, and other IMF loans have not been tapped.

In sum, 1993 saw modest reform and modest western support. We cannot be satisfied with this outcome, and must seek an intensification of Russian reforms and western support that advances as quickly as those reforms.

It is particularly important that Russian stabilization go forward and that Russia have the benefit of western support for this effort. As I have said, Russia's central economic challenge is to stop inflation and stabilize the value of the ruble. Only then can Russia make the most of the achievements reached to date; only then can Russia stem capital flight, draw large-scale resources into the modernization of industry, and attract significant foreign investment, all of which are needed to restructure the economy.

The key to stabilization is keeping the budget deficit from leading to a flood of money printing. From the beginning of the economic reforms, the budgetary arena has been the principal battleground. This was to be expected, as stabilization by its nature pits powerful interests against one another and leaves the Government to balance competing claims on fiscal resources.

Deficit reduction in Russia requires cutting budgetary subsidies to industry and building an appropriate and reliable tax base. Russia's problem is more complex, however, for it is not only facing a runaway budget, but is also undergoing an historic economic transformation. That transformation presents unprecedented hardships for the population. If Russia is to shift its focus from *industry* to *people*, as it must, not all spending cuts can go to deficit reduction. Rather, some must go to free up resources for social support and social infrastructure.

Western financial support can play an important, albeit partial, role in managing Russia's fiscal problem, by providing Russia an additional and non-inflationary revenue source: the ruble sale proceeds of western loans and grants. That revenue source can help Russia to stop printing money without eliminating fully the gap between spending and revenues. A \$4 billion IMF loan, for example, could cover budget spending equal to 1½ to 2 percent of GDP. It is the job of the IMF to help the Russians strike a balance between domestic policy adjustment and western financial support, so that both contribute to the stabilization of the country.

The debate over the wisdom of offering such support parallels our debate here in the United States over the wisdom of tax increases. It is often pointed out that tax increases will not be effective in reducing the budget deficit if they are associated with extra spending. Similarly, western financial support for Russia would not be effective were it merely to support more subsidies for outmoded state enterprises. It is for this reason that in our support strategy, large-scale western financing is conditioned upon fiscal and monetary discipline in Russia.

CRITIQUES OF THE SUPPORT STRATEGY

Before discussing in greater detail how we aim to proceed in 1994, let me say a few words about some of the critiques of our approach.

1. *Western support is wasteful, because reform is dead.*

Some say that the United States is wrong to go on offering support to Russia. Russian reform has been a failure and now reforms have stalled. Further support would be wasteful.

As I have argued, Russia has made real progress and is on its way to a market economy. Every day, new businesses are created, old businesses are restructured, and the institutions of a market economy appear. These changes, taking place outside of the reach of government, are gathering momentum, but need time to spread and to deepen.

The question of the hour is not whether reform can work, but whether reform will be continued. We expect Russian reform to continue, but needless to say, on this count there can be no guarantee. But our strategy of core support for bottom up reform and conditional support for top down reform is calculated to lessen the risk of wasteful spending.

We must be mindful that modern economic history teaches that successful stabilization and reform programs on all continents have been associated with external

financial assistance. The West has been correct to support Russian reform, and we must hold out the prospect of further help.

We must also be mindful not to fall into the trap of a self-fulfilling prophecy of failure. If the risk of failure deters the West, including the IMF and World Bank, from providing support, we may find that by withholding support we have helped to bring on failure. While such a choice might seem justified after failure is evident, it may well have been unwise.

2. *The West should stop pressing for bold reform.*

Some say that the West has been wrong to press for bold market reforms, and to condition support on those reforms, arguing that a more gradual approach would be more successful.

Throughout the region, bold reform has led to the best results (see attached chart). It is no accident that Poland, the Czech Republic, and the Baltic nations—where budget deficits have been controlled, credit growth contained, and inflation curbed—have experienced relatively small declines in output and have seen their firms compete successfully on world markets. In fact, Poland, which launched a bold reform program in 1990, is one of the fastest growing economies in Europe and its stock market saw the largest rise of any in the world in 1993.

Other countries in Eastern Europe and the Former Soviet Union that have tried to chart an easier and slower course have seen their transformations stall. The lesson of Ukraine's experience last year was that their attempt to lessen painful dislocations by slowing liberalization and avoiding budget cuts produced a painful reality of hyperinflation and industrial paralysis.

Reform is like a bicycle. The faster you pedal, the easier it is to stay up. But if you stop pedalling, you are sure to fall. Russia cannot escape the need for bold economic reform.

Some critics point to the case of China as a successful example of gradualism. This comparison does not recognize the crucial differences between the economic transformations of China and Russia. China began its transformation with 70 percent of its labor force engaged in agriculture, much of that subsistence farming. Russia began its transformation with 85 percent of its labor force employed in state enterprises, in industry and large collective farms. China's transformation involves the initiation of new, market economic activity; Russia's transformation involves more pain, because it requires a massive reorientation of labor and capital from outmoded heavy industry to consumer-oriented production. Gorbachev's Perestroika and the communist-led reforms in some Eastern European countries during the 1980s, which were failed gradualist experiments, show that the Chinese experience simply does not translate to this region.

3. *More western support should have flowed in 1993.*

And others say that the West has been too reluctant to provide financial support for Russia, arguing that more loans should have been made available in 1993.

As I have said, 1993 was a year of modest Russian reform and modest multilateral lending. It is fair to say that bolder reform and greater lending would have been better. But it is also clear that higher lending levels absent reforms would only have compounded Russia's problems. As long as the Russian Central Bank offers easy credits, there should be no surprise if there is capital flight. Unless the tap is turned off and the value of the ruble stabilized, everyone has an incentive to borrow rubles, buy dollars, and invest abroad. Absent further reform, further dollar loans to Russia would only pass through the exchange market and end up in Swiss bank accounts. Russia would end up with foreign debt and nothing to show for it.

THE LESSONS OF RECENT EVENTS

Some say that the election was a vote against reform and the western strategy of support. Clearly, it was a setback to the reformers who were unable to command a working majority in the Parliament. It is much less clear, however, that election was a vote against reform.

Few would dispute that the reformers ran a poor campaign. These, unfortunately, are the growing pains of democratization. The inexperience of the reformers as politicians showed as they splintered into several parties and failed to focus on the economic reform issues at the heart of their program.

With some key reformers departed from government, many fear that the interests of the industrial lobby will again lead to inflationary credits and subsidies and a slowing of reform. The election gives us no reason to believe that there is a popular base for such an approach. The industrialists and centrists proved to have almost no constituency in the parliamentary election, as parties such as Arkady Volsky's Civic Union failed even to meet the 5 percent threshold for party representation.

Moreover, in the wake of the election it appears that the Russian people continue to favor economic reform. Just last week, the Washington Post reported that new opinion polls suggest that few Russians expect the economic reforms to be reversed. A poll reported in last week's Economist Magazine shows that the average Russian still wants to see a market economy develop, and has as his main concern Russia's high inflation.

I conclude that recent events, including the election result, neither call into question our commitment to engage with Russia nor our strategy of core support for bottom up reform and conditional financial support for top down stabilization and structural reform. Moreover, nothing in the experiences of Eastern Europe or the other nations of the former Soviet Union suggests an alternative to bold economic reform. It is hard to see how a more gradualist approach to economic reform in the runup to Russia's election would have helped produce a mandate for reform.

Recent events do, however, suggest three points that should be borne in mind.

- President Clinton has decided that our policy must remain anchored in support for rapid economic reform and democratization, but must evolve to take better account of Russia's political realities and the need to place greater stress on the social dimensions of economic transition.
- The United States also wants to see support for reform in the other nations of the former Soviet Union, both to help those nations and to help Russia. Russia's prospects are closely linked to the prospects of the rest of the former Soviet Union.
- The West, and in particular the IMF and the World Bank, must be poised to support Russia actively when we see a window of opportunity for economic reform. One never knows how long a window of opportunity will stay open.

Let me amplify the first point, on the importance of the social dimension of reform.

The need to address the social dimension of change is not unfamiliar here at home. For there is a parallel in the conflict that arose in the NAFTA debate, where it was necessary to address the problem of short run dislocations, to reach a societal consensus on changes that would bring overall economic improvements.

Russia faces substantial hardship as it seeks to shed its communist inheritance. An estimated one-third of the people live in poverty. The Russian State Committee on statistics reported last week that the life expectancy of Russian men has fallen from 62 to 59 years of age, some 13 years less than for American men.

Addressing these hardships is a complex and difficult task. Part of the task of addressing social needs is tackling inflation. Inflation erodes the safety net directly, as next month's benefits are calculated on the basis of this month's wage levels. Thus, inflation is the cruelest tax for pensioners and the unemployed.

But, the social safety net needs to be reknit. Under the Soviet Union, a universal cradle-to-grave safety net existed which was highly inefficient and bankrupted the country. Russia's social infrastructure must be streamlined and targeted to be consistent with market realities.

To be able to pay for a social safety net, Russia must free up budget resources by reducing wasteful subsidies to state firms. These subsidies are especially harmful where they have sustained production for goods that people do not want or with value that is less than the costs of production.

But, the West has a role to play in helping Russia address its social needs. We can provide technical assistance for the effort to create a social safety net and financial support for social infrastructure through the World Bank.

U.S. SUPPORT FOR RUSSIAN REFORM IN THE PERIOD AHEAD

In the aftermath of the elections and the formation of the new government, Russia has again reached a critical juncture on the path to reform.

At the Summit and again in recent weeks, President Yeltsin has reaffirmed his commitment to reform and building a market economy in Russia. He and Prime Minister Chernomyrdin have stated that their commitment to reform is "irreversible." The Administration strongly welcomes these statements.

But other developments have raised our concern. Leading reformers have departed the Cabinet. Prime Minister Chernomyrdin recently stated that monthly inflation would average 20 percent in the first half of 1994 and fall to 15-18 percent by end December. This is far higher than the 3-5 percent target for December 1994 that was included in the Government's November 1993 policy statement. In recent weeks, the ruble has fallen some 20 percent in value and privatization vouchers have lost one-quarter of their market value.

Later this month, Russia will announce its 1994 budget and issue a new economic statement. We look forward to those steps. The choices Russia will soon make are certain to bear heavily on its economic destiny.

We aim to advance our strategy of support along the following lines:

First, bilateral support will remain at the core of our assistance effort. It is helping Russia put in place the building blocks for democracy and market reform. It must continue.

Second, greater attention will be given to supporting Russia's social infrastructure. The West can help develop a targeted program of social infrastructure support, through our bilateral technical assistance programs and through IFI financing. During the Moscow Summit, President Clinton assured President Yeltsin that the G-7 will intensify its efforts to implement the SPRP, including the World Bank's support for the social safety net.

Third, we will call upon the IMF and World Bank to remain engaged in dialogue with Russia and to move swiftly to support stabilization and reform. We want to see western support advance as quickly as Russia's reforms. We will watch closely the policy decisions being taken in Moscow, try to understand Russia's stabilization prospects, and judge when further IMF loans and fast-disbursing World Bank loans are warranted.

In this regard, the G-7 has a responsibility to monitor this collaboration and ensure it is as effective as possible. Later this month, the G-7 Finance Ministers will meet with IMF Managing Director Camdessus, World Bank President Preston, and the leading economic and financial officials of the Russian Government.

Fourth, the World Bank should continue to help Russia meet its pressing infrastructure needs. As I have noted, Russia's structural adjustment is well underway. Project lending is essential for furthering this adjustment, by building highways and homes, rehabilitating the oil sector, improving the transport and communication network and developing rural infrastructure.

Fifth, we will do all we can to support the transformations of the other nations of the former Soviet Union. As part of our effort to help Ukraine advance its reforms, President Clinton has decided to expand our bilateral support for Ukraine. We will also urge the IFI's to support economic reforms actively across the former Soviet Union.

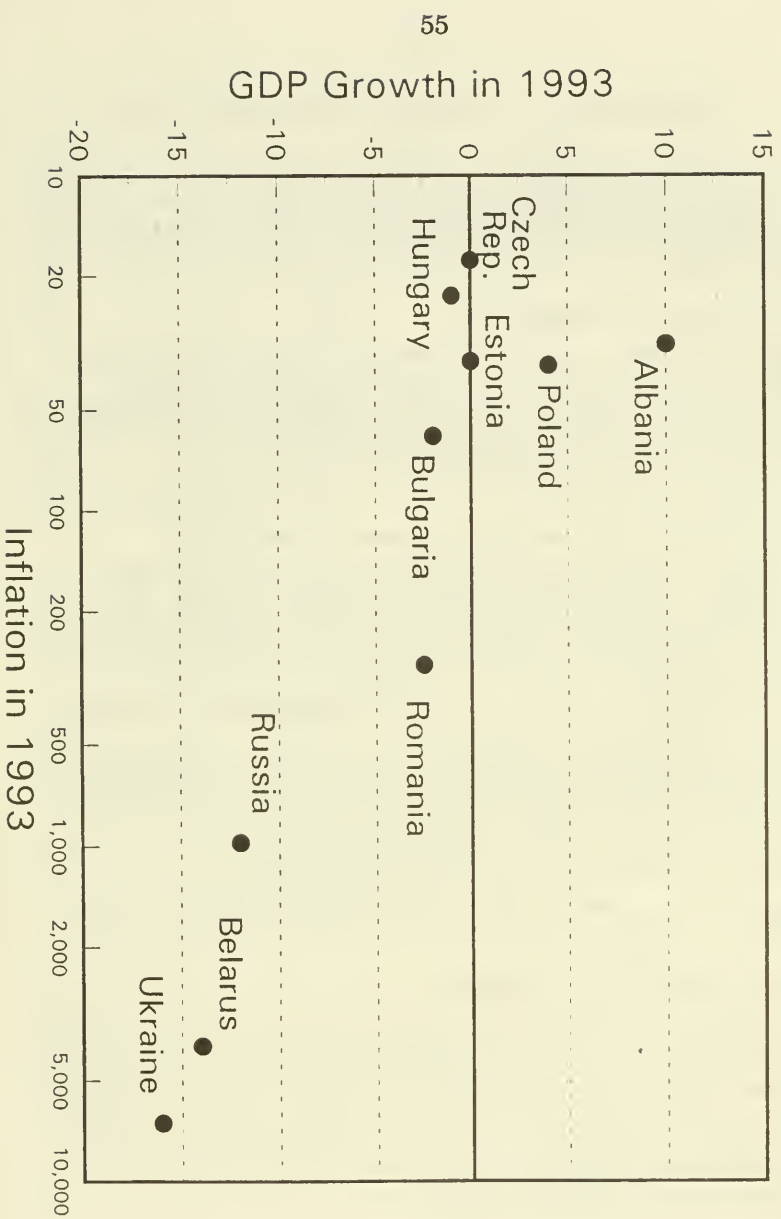
CONCLUSION

Watching events unfold in Moscow, one is struck by the drama of the politics and the fits and starts of economic reform. As we follow these events, let us not forget that dramatic stories can have happy endings.

As I have observed at other points in Russia's economic reform process, it is instructive to recall the aftermath of another revolution. Thirteen newly independent states formed a confederation. Each had its own currency and over the years several experienced runaway inflation. The confederation could not raise its own taxes, and at least one large state withheld revenues from the confederation to pay its own debts. The legislature of another state ran a land privatization scheme in which a large parcel of land was sold to three different buyers! Speculators won and lost fortunes gambling on land values and whether their governments would honor their debts.

This was the American confederation. But that was not the end of the story. A constitution was adopted and in our case a federation formed. The rule of law was established. The first Secretary of the Treasury, Alexander Hamilton, launched America's stabilization program. He balanced the budget and solved the wartime debt problem. Within three years output and trade began to recover. Democracy and a prosperous market economy were born.

GDP Growth and Inflation



The G-7 agreed their export credit agencies (ECAs) could provide \$10 billion to help Russia acquire needed capital imports. Preliminary reports suggest roughly \$4 billion in ECA assistance was committed in 1993. The U.S. EximBank will provide up to \$2 billion under its oil and gas sector framework agreement.

IV. Official Debt Rescheduling \$15 \$15

In April 1993, Paris Club countries rescheduled roughly \$15 billion of official principal and interest payments due in 1993. Treasury Secretary Bentsen and then Russian Finance Minister Fedorov signed a bilateral accord in September to implement the April agreement. Russia has since paid \$450 million in arrears, and the United States rescheduled \$1.1 billion.

TOTAL MULTILATERAL SUPPORT \$43.4 \$22.2

Special Privatization and Restructuring Program (SPRP)

Responding to a U.S. proposal, G-7 Heads of State, the World Bank, IBRD, and IFC agreed in Tokyo to create the SPRP, in cooperation with international financial institutions, to assist in restructuring large firms. The program will mobilize \$3 billion and focuses on an initial period through 1994. The SPRP will provide equity, loans and ECA support for enterprise restructuring. A network of six or seven regional venture funds is being established to make equity investments in Russian firms.

The United States is contributing \$100 million in bilateral grant support under the SPRP to create a Fund for Large Enterprise Restructuring (FLER). The remainder of our \$125 million grant contribution will be used to provide equity in cooperation with an international financial institution. The United States also pledged \$250 million in ECA support under the SPRP.

The World Bank is developing a \$500 million Social Safety Net Adjustment Loan under the SPRP to help alleviate social burdens as Russian firms restructure.

Support Implementation Group (SIG)

At the Vancouver Summit, Presidents Clinton and Yeltsin agreed to explore creation of a body to coordinate external assistance to ensure more timely support for Russian reform. The United States took the lead in creating the SIG, which was endorsed by the G-7 in Tokyo. The SIG will be in Moscow, and will work to overcome bottlenecks in disbursement of bilateral and multilateral support on both the Russian and Western sides. The SIG initiated its activities on September 1 and will now intensify its work under its U.S. Director, Michael Gillette.

MULTILATERAL SUPPORT FOR RUSSIAN ECONOMIC REFORM

In April 1993 in Tokyo, G-7 Foreign and Finance Ministers developed a large multilateral support program for Russia to provide up to \$43.4 billion over the 14-month period through the 1994 Naples Summit. That support was conditioned on the pace of reform in Russia. Below is a status report on that support (amounts are in billions of dollars) and other G-7 support initiatives.

<u>MULTILATERAL SUPPORT PACKAGE</u>	<u>AMOUNT</u>	<u>APPROVED</u>
I. <u>Initial Stabilization Support</u>	\$4.1	\$2.0

In 1993, the IMF created a new lending facility, the Systemic Transformation Facility (STF), to provide initial support for stabilization and serve as a bridge to a full economic program. Russia is eligible to draw \$3.0 billion under the STF in two tranches. The first \$1.5 billion tranche was drawn in July 1993. Russia and the IMF have not yet agreed on the terms for the second \$1.5 billion loan.

The World Bank indicated it could provide up to \$1.1 billion in initial stabilization support through critical import loans. Since April, the Bank has obligated the remaining \$500 million under a \$600 million critical import loan made in 1992. It will offer a second critical import loan of \$600 million once agreement is reached on the second STF disbursement.

II. <u>Support for Full Stabilization</u>	\$10.1	\$0
---	--------	-----

The G-7 envisaged that following the support of the STF, Russia would move toward full economic stabilization with the support of an IMF (standby) loan of up to \$4.1 billion. Lack of progress under the STF has delayed progress on a standby.

The G-7 also agreed to create a \$6 billion currency stabilization fund to support the ruble, once Russia had implemented a rigorous standby program for several months.

III. <u>Support for Structural Reforms</u>	\$14.2	\$5.2
--	--------	-------

Structural support for Russia is needed to help privatize industry, build market institutions and infrastructure, and develop sectors of the economy such as energy and agriculture.

The World Bank has indicated its willingness to provide up to \$3.4 billion in new loans to support restructuring. To date it has approved a \$610 million oil rehabilitation loan. The EBRD also approved \$250 million in co-financing for this loan.

Under the \$300 million Small and Medium Enterprise Fund (SME) initiative, G-7 countries and the EBRD each will provide \$150 each million to finance small emerging entrepreneurs. The EBRD and G-7 have set up a \$10 million SME pilot project which, after review, will provide the basis for the entire project.

PREPARED TESTIMONY OF THOMAS W. SIMONS, JR.

Thank you, Mr. Chairman, for the opportunity to testify today before your committee on the condition of the Russian economy and the implications for the United States.

We continue to witness a remarkable transition in Russia, as new political and economic structures are established to replace the old, ineffective system. The stakes are historic, but the pace of change is uneven, and the outcome uncertain. The uncertainties give us cause for both concern and hope.

The past several months have been a time of difficulty and challenge for the reform process in Russia. The December elections gave communists and nationalists substantial representation in the new parliament, and several prominent reformers have resigned from the government this year. Along with recent suggestions that the Government intends to boost subsidies to state-owned enterprises, the specter of significantly higher inflation and a slowing of economic reform are on the horizon. This is cause for concern.

At the same time, there has been real progress in significant areas over the past year, and we know that the impulse for reform is alive and well at various levels across Russia, both in the central offices in Moscow and in the regions. President Yeltsin has strongly reaffirmed his commitment to reform. Prime Minister Chernomyrdin has said that inflation remains the number one problem and would be solved through adherence to strict fiscal and monetary policies. So there is cause for hope as well as for concern.

These seemingly contradictory signs reflect the Government's struggle to map a future course that will maintain the necessary political support for ambitious economic reform. More than ever before, the Russian government faces the challenge of governing in a democracy. And the fact is that we cannot yet know the concrete policies they will adopt, and how they will affect the course of reform and stabilization over the coming year.

POLITICAL REFORM IN RUSSIA

While the recent focus on personalities—the makeup of the new cabinet and the antics of Zhirinovskiy—is understandable, we should not allow it to obscure the major advances Russia has recently made in putting in place a political framework that will ease the implementation of the eventual broadening and deepening of the reform process.

First, as a result of the ballots cast by Russian voters in December, that country—for the first time in its history—has in place a democratic Constitution that protects and defends basic human and civil rights. Russia now has a stable set of rules within which all politicians must operate. We welcomed, encouraged, and supported the approval of this Constitution by the Russian people. We also welcome—and will work to support the additional measures that the Russian government will take in the future to build on the Constitution to create lasting democratic institutions.

Second, we need to keep in mind that this Constitution calls for a strong executive. It will allow President Yeltsin leeway to move forward with his reformist economic policy, democratic domestic initiatives, and progressive and reformist foreign policy. President Yeltsin has assured President Clinton that he intends to use these powers to the full.

Third, while many in the new parliament may seek to slow reform down, we should not forget that reformers and independents likely to side with them on individual issues are in rough balance with opponents of reform in the lower house; in the upper house reformers hold a somewhat stronger position, including the speakership. This fact, combined with the strong presidential powers conferred on Boris Yeltsin by the new Constitution, means that, overall, the forces of reform are down, but clearly, very much not out. And there is clearly much that is needed and much that is possible in terms of building the legal and regulatory infrastructure of the new, modern economy based on market principles and individual decisions.

ECONOMIC REFORM

Despite the admittedly mixed picture in the Russian macro-economic situation, important strides toward a market economy continue at the grass roots level.

A tectonic shift has occurred. Over one-third of the labor force is now employed in the private sector and more than three quarters of Russia's small businesses and retail shops are now privately owned. Over 7,000 medium and large enterprises are in private hands. Roughly 55 million Russians own a stake in a private venture. Another 55 million Russians have invested in mutual funds which own shares in privatized firms.

Prices have been freed on more than 90 percent of goods and services. The contraction in the economy is slowing. Exports are up and inflation in December was the lowest since September 1992—although it edged back up this January.

Of course, there is a long way to go. Privatizing firms is only a first step in developing profitable, job-creating enterprises. Production is still falling, and the inflation figures are favorable only in the most relative sense. At 12 percent a month, prices double every six months. The Russian economy, moreover, has yet to face widespread failure of firms and unemployment. Firms producing products without markets continue to subsist by writing rubber checks, in order to keep workers in dead-end jobs and a social safety net for which they have no resources.

The challenge for Russia is to resist the natural tendency to slow structural transformation in response to the political tension it creates. Slowing structural reform only delays the point at which Russia can halt the economic decline and point to renewed and healthy economic growth. Only such growth can fund an adequate, modern social safety net, and that growth requires a vibrant private sector and dramatically increased domestic and foreign investment which will only come in a stable macroeconomic environment.

THE SOCIAL CONSEQUENCES OF REFORM

Of course, economic transformation cannot occur without disruption, dislocation and real hardship in the lives of individual Russians. We cannot ignore this fact; millions of people will be affected and it will have significant political consequences.

However, slowing reform will not reduce the hardship. The economic drop has been caused by the failure of the centrally-planned, state-controlled system. It cannot be reversed by pumping in subsidies and credits derived from printing money. This only fuels the inflation that wiped out savings, threatened the ability of the millions of Russians on limited incomes to meet basic needs and led to capital flight.

Instead, social dislocation needs to be addressed through carefully targeted programs to ease the transition, protect vulnerable groups, create the new skills and expertise needed to create the goods and services needed in a market economy, and equip Russian government at all levels to manage and fund social services for the genuinely needy.

Our bilateral assistance program is designed to help this adjustment. Thousands of Russians will benefit from our exchange, education and training programs. Our privatization, trade and investment programs are aimed at creating new companies and restructuring existing ones to allow them to survive and prosper and create new job opportunities. They and the individuals who work for them will be in a position to fund, through their taxes, the social programs modern societies require. Our technical assistance helps governments create the efficient structures for serving those needs that must replace the blanket coverage provided by the old socialist firm to its employees. And we provide humanitarian assistance to help Russia deal with the most urgent needs, particularly in the medical area.

As Under Secretary Summers has testified, the multilateral development banks also have an important role to play in easing the transition. This was recognized by the G-7 when they created the Special Privatization and Restructuring Program at the Tokyo Summit in July. In particular, the World Bank can help the Russians with the transition of social services from enterprises to regional and local governments—thus removing a major obstacle to successful privatization. The EBRD can provide lending and equity investment to the private firms that will provide the new jobs for Russians left unemployed by the restructuring.

Ultimately, responsibility for transformation rests with the Russians. We can offer advice and support, but they must decide on the course and map out the basic strategy. This is the task now before the new Government and parliament. It faces regional and local leaders throughout the entire Federation.

We stand ready, as always, to exercise our leadership in the G-7, and our influence in the IFI's, on behalf of Russian reform, but our support for reform is, also as always, contingent on Russia's own actions. The Government has made a commitment to continue reform and we need now to see how that commitment is translated into specific policies and actions. The Western community should be ready to respond quickly and aggressively with support, both bilaterally and from the international financial institutions if the Government adopts the tight fiscal and monetary policies to rein in inflation and provide the foundation for private investment and growth.

BILATERAL ASSISTANCE

While the support of the IFI's is, appropriately, very much dependent on the stabilization and reform policies of the central government, our bilateral assistance has been designed to move forward independent of the ups and downs of the macro-

economic effort. It is directed at the grass roots, beyond the Moscow city limits, as well as at the reformers in the central institutions who must carry the struggle for modernized legal and regulatory infrastructure, for privatization, for rule of law, for independent media, for the new mechanisms of the modern democratic state. It is intended to strengthen private enterprise and foster the institutions of a functioning market and the strengthening of the democratic process.

Our assistance does not go into government coffers, but rather goes directly for carefully chosen specific projects and activities to help restructuring and reform. From setting up privatization auctions through training commercial bankers to promoting joint ventures with U.S. companies, our bilateral assistance provides concrete, nuts-and-bolts help in transforming the economy—and from the bottom up. The structural transformation will take years to complete, but it is on our clear interest to encourage it as quickly and efficiently as we can. Reform has also brought with it the decentralization of political and economic power throughout the country. Moscow no longer holds all the keys to the economic future of Russia. This can be seen in the difference among regions and individual communities, as in the degree of new economic activity and the health of local economies. Of course, the Central Government's ability to provide a stable currency and the appropriate legal framework has a profound effect on the local efforts. Dramatic and significant progress is being made in spite of a still uncertain legal climate. U.S. bilateral assistance has played—and will continue to play—an important role in facilitating this program.

U.S. STAKE IN SUCCESS OF RUSSIAN REFORM

As Ambassador Talbott has said, we remain firm and steadfast in our commitment to help Russian reformers throughout their difficulties. The path will not be easy. It is unlikely to be a straight line. But our stake in seeing reform succeed is enormous. The benefits, to the U.S. and the world, of the positive steps Russia has already taken to reform its relations with the rest of the world are dramatic. These changes in Russian policy have allowed us to conclude treaties cutting nuclear arsenals by two-thirds, removed Russian troops from central and Eastern Europe, and fostered new possibilities for international cooperation on non-proliferation, narcotics control, environmental protection, and counter-terrorism. At the recent summit in Moscow, we made important advances in a number of areas, including helping Ukraine fulfill its international commitments concerning nuclear weapons and encouraging Russia's further integration—through participation in NATO's Partnership for Peace—into European collective security arrangements, and moving forward the process that must lead to Russian troop withdrawal from the Baltic states.

All of these positive trends in Russian foreign policy could be jeopardized, however, if Russia's reformers do not succeed. If reform fails, forces of extremist nationalism, xenophobia, and neo-imperialism could become ascendant. The consequences of this for U.S. policies would be both obvious and familiar:

- more tax dollars spent on defense;
- continued potential threat from weapons of mass destruction;
- closure of promising new markets for U.S. and promising new opportunities for U.S. investment and expanded, mutually advantageous economic cooperation;
- loss of a potentially powerful and reliable partner for diplomacy in dealing with emerging global and regional issues.

I remain an optimist in believing that Russia and the U.S. will—whatever the bumpy patches—stay on the road of partnership and cooperation. But I am also a realist in acknowledging that what happens inside Russia will be decisive here. Russia must be at peace with its own people if it is to be at peace with its neighbors—and with us. It is therefore imperative that we remain engaged, doing what we can when we can, to encourage the success of the historic internal transformation that Russia is undergoing by helping Russians down the difficult path they have chosen so far.

PREPARED TESTIMONY OF MARSHALL I. GOLDMAN

KATHRYN W. DAVIS PROFESSOR OF RUSSIAN ECONOMICS AT WELLESLEY COLLEGE
AND ASSOCIATE DIRECTOR OF THE RUSSIAN RESEARCH CENTER

It is misleading to focus on whether or not this or that set of policies or a more generous outpouring of support would have "saved" the Russian reform effort. To provide perspective, it is necessary to remember that for three years now the German government has been spending over a hundred billion dollars a year to resuscitate East Germany, so far with only meager results. But even if the West could

come up with a comparable amount for Russia, it would still not have been enough. Western reformers have failed to appreciate that over a seventy year period, Soviet leaders did all they could to create a system that would take decades to revert to a market system. When it became clear that these expectations would not be attained, rather than accept the fact that they were unrealistic, there has been a search for scapegoats and saboteurs. As former President Richard Nixon put it "who lost Russia?"

What makes the Russian economy so resistant to reform? After seventy years of conscious effort, Soviet leaders transformed the Soviet economy into something that was unique. This is hard for well-trained economists to accept. Western economic theory insists that everyone in the world ultimately responds the same way to the same economic stimuli. But because they believed that socialist central planning was superior to the market system, Soviet leaders did all they could to make sure that the Soviet people would respond differently, or at least take considerably longer than those in other countries to respond to higher prices and market incentives, and that any attempt to revert to a market system would trigger economic booby traps.

How did they do that? They concentrated on reconditioning public attitudes as well as altering the institutional base of the economy. For example the Soviet government did all it could to condition its people to the notion that anyone who engaged in private trade was committing an antisocial act. To reinforce that feeling, anyone caught producing or trading goods for themselves was charged with committing an economic crime. Economic crimes were punishable by death.

It is the institutional transformation, however, that most distinguishes Russia even from other Communist countries like Poland where market reform did work. In Russia for example all private farms were destroyed and transformed into very large collective and state farms averaging about 500 workers on each farm. (By contrast, 80 percent of the farms in Poland were never collectivized.) The changes were equally far-reaching in the commercial and industrial sectors. It was not only that all business activity was nationalized, but that to eliminate the wastes inherent in the market system, small shops were closed down or consolidated. This fits in nicely with Marxist ideology that service activities were parasitical. Thus over the course of seventy years the marketing infrastructure was drastically contracted if not destroyed and when Gosplan and Gossnab (the state central planning commission and state supply organizations) were abolished in the late Gorbachev era there was no market infrastructure to take its place.

Industry was subject to even more radical surgery. Soviet industries were purposely converted into state-owned monopolies that made possible economies of scale that competitive firms could not achieve. Soviet engineers purposely designed their factories to be as large as possible. Over 70 percent of Soviet factories had a workforce of over a thousand employees.

Against this background any effort to switch to a market-determined system was bound to create enormous upheaval. Moreover, given the booby traps, there was a real danger that while a radical wrenching of the economy might bring some desirable changes, overall it might exacerbate the situation. Given the lack of a responsive marketing infrastructure and a competitive industrial base, a rapid crackdown on credit creation and loan issuance along with an enforced insistence on bankruptcy at all levels of society would have precipitated massive factory closings and unemployment. While some closing and consolidation is necessary and desirable, a massive upheaval would have been the likely result of a rigorously applied form of shock therapy. This in turn would have triggered political and social chaos.

The choices available to the government in January 1992 were not good ones. Without a responsive marketing infrastructure, whatever they did was likely to create social and political upheaval. Under the circumstances it might seem defeatist but since inflation was all but inevitable, perhaps less attention should have been devoted to macro concerns and more to fostering private farming and new business formation. The point is that no policy, whether it be more credits, a ruble stabilization fund, a currency reform, tight credit, or an increase or decrease in government subsidies could have produced the economic transformation that was needed. That is why it is unfair to seek out scapegoats for the failure of the reforms. No one set of reforms, reformers, or lending organizations could have done enough to transform Russia in anything less than a decade or two.

Given the trauma of the last few years, what should we expect now? With or without shock therapy, the prospects for the Russian economy are not bright. Inflation will probably increase, but some of that is the consequence of commitments in December 1993 by the old government immediately before the elections which Yegor Gaidar and Boris Yeltsin left to be financed in 1994. The danger is that increased economic instability will lead to increased political discontent and even more support for anti-reform groups on the far right and far left. Renewed concern about

Russia's international intentions might cause the U.S. government to reconsider cut-backs in U.S. military spending. As troubling as a return to Russian trouble-making might be, a more expansive Russia is likely to focus, at least initially, primarily on the recreation of the Russian empire, not the reinstitution of the international cold war. In any case, failure of the Russian economy to recover is not likely to have much impact on U.S. imports or exports, except in agriculture. If the Russian economy should recover, there are likely to be fewer wheat exports from the United States.

Under the circumstances, what kind of aid should the United States support? Certainly, grants and credits are absolutely necessary, but to prevent corruption and even larger flight of capital, they should only be extended where there can be some way of assuring that those funds will be properly used. For the time being we should continue to support international aid efforts but in doing so, we should be careful not to compromise the efforts of the IMF. If it is decided to institute special, more lenient terms for Russia, then it may be better to establish a new facility much like the European Bank for Reconstruction and Development in the banking sector. As for U.S. bilateral aid, for the time being at least, this means no ruble stabilization fund and minimal support for the privatization effort unless it can be shown that the specific loans and grants will increase competition. In any event, it is important that only minimal funding be funneled through to U.S. consulting firms and Beltway Bandits. The Russians benefit minimally, if at all; from the ever-growing reports and overhead being created by this type of U.S. spending.

The most logical approach would be to foster the creation of new businesses through increased reliance on the Russian-American Enterprise Fund. If administered properly, this will foster the building of new business institutions, many of which will be outside of Moscow. Toward the same end, the United States should set up a Farm Fund and a Marketing Fund. In this way the United States government, as well as private investors and other lending entities can help recreate the institutional base destroyed during the Communist era. This means no quick fixes, but it probably is the most realistic approach to ultimate reform.

Testimony to the Committee on Banking,
Housing, and Urban Affairs

United States Senate

February 5, 1994

Professor Jeffrey Sachs
Harvard University

Mr. Chairman, I am grateful for the opportunity to testify before the Senate Banking Committee this afternoon, on the important issue of Western Assistance to Russian Economic Reforms. Specifically, I will focus my brief comments on the issue of the International Monetary Fund. In recent weeks, I have been very critical of IMF procedures vis-a-vis Russia. I continue to believe that the IMF approach has been unhelpful for the very goals that the IMF is trying to pursue in Russia: low inflation and macroeconomic stability. I would like to take this opportunity to explain my position, and to make suggestions about an improved Western approach to assisting Russia in its economic reforms.

Along with the IMF, I believe that reducing Russian inflation is the most pressing policy issue facing the Russian Government. In my opinion, high inflation in Russia could lead to profound social and political instability, and could even undermine the fragile democratic structures in Russia, thereby posing significant risks to global security. John Maynard Keynes said it best in 1919 in the Economic Consequences of the Peace:

There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.

The debate with the IMF is therefore not about goals, but about means to achieve those goals. I do not seek to weaken IMF conditionality vis-a-vis inflation, but rather to raise the chance that it can be successful. I would

change the timing and character of aid to Russia to have a better chance of succeeding in reaching low inflation. To understand my differences with the IMF, it is necessary to put the debate in formal economic terms. I apologize for the technicalities that follow, but they are necessary to lay out my argument. Otherwise, my critique of IMF practices will continue to be misunderstood as an attack on the goal of low inflation itself.

Basic analytics of monetary stabilization

The basic cause of high inflation in Russia is rapid growth of the money supply. To put matters in the simplest analytical form (which is a simplified version of the "financial programming" approach used by the IMF), the rate of monthly price inflation is equal to the rate of growth of the money supply:¹

$$(1) \Delta P/P = \Delta M/M$$

In turn, the rate of growth of the money supply is closely linked to the budget deficit. Let D be the level of the budget deficit, expressed in rubles. Let Y be the level of GDP, expressed in rubles. Let d be the ratio of the deficit to GDP. Thus:

$$(2) D = d * Y$$

There are three ways to finance the budget deficit. The government can: (1) borrow from the central bank, (2) borrow from abroad, or (3) borrow from the market for Russian bonds within Russia. When the government borrows from the central bank, the money supply rises. When the government borrows from abroad, the foreign debt increases. When the government borrows from the domestic market, the domestic debt increases. Let ΔM be the change in the ruble money supply; F be the change in the foreign debt (expressed in current rubles); and B be the change in the domestic debt. Also, let $f = F/Y$ (foreign borrowing as a percent of GDP), and $b = B/Y$ (domestic bond borrowing as a percent of GDP). Finally, define "monetary velocity" as $V = Y/M$.

Thus, there is a basic identity, showing that the budget deficit must be financed in one of three ways:

¹In fact, extensive statistical analysis suggests that Russian monthly inflation is linked to the money supply growth of four months before. I ignore this lag in the exposition for the sake of simplicity and clarity. For evidence on the basic relationship, see S. Fischer, "Prospects for Russian Stabilization in the Summer of 1993," and J. Sachs, "Prospects for Monetary Stabilization in Russia," in Anders Aslund (ed.), Economic Transformation in Russia, London: Pinter Publishers, 1994.

$$(3) D = \Delta M + F + B$$

Combining these three equations, and the definitions for d , f , and V , we have an equation for inflation that is really at the core of the debate over IMF strategy:

$$(4) \Delta P/P = (d - f - b) * V$$

This is a famous equation that is at the core of standard analyses of inflation, including the IMF's. It says that the inflation rate $\Delta P/P$ is an increasing function of the budget deficit as a percent of GDP, d . The higher the budget deficit as a percent of GDP, all other things constant, the higher is the inflation rate. This is the core analytical basis of the IMF recommendation to cut the budget deficit as the way to end high inflation. Similarly, the higher the monetary velocity V (for a given budget deficit), the higher is the inflation as well. If there is a "flight from the ruble," then V rises, and the inflation rises as well, even if the budget deficit as a percent of GDP remains the same.

Equation (4) says something else, however, that is usually ignored by the IMF, and that has been almost ignored in the IMF's negotiations with Russia. Inflation can be reduced not only by cutting the budget deficit but by shifting the way it is financed. For the same budget deficit, a reduction in ΔM matched by a compensating increasing in F and B will lower inflation. In other words, if the deficit is financed for by foreign borrowing or by domestic bond financing, rather than by central bank financing, it is possible to have low inflation together with a sizeable budget deficit.

Before applying equation (4), I must add one more complication. In fact, the money supply can grow not only through central bank loans to the budget, but also through central bank loans to enterprises (usually via commercial banks). Thus, to apply equation (4) we must interpret d more broadly, as the budget deficit plus central bank credit to banks (all as a percent of GDP). The IMF has certainly been on target in pressing the Russian Central Bank (RCB) to limit credits to the enterprise sector. By the end of 1993, RCB credits to the enterprise sector were running at between 1 and 2 percent of GDP.

Now let's apply the equation. At the end of 1993, the Russian budget deficit was approximately 9 percent of GDP, plus another 2 percent of GDP in credits to the commercial banks that should be added to calculate d .² The

²There is some ambiguity about the precise size of the fourth-quarter deficit. The recorded deficit of 9 percent is based on cash flow accounting. There were several categories of "unfulfilled obligations" (arrears). Finance Minister Boris Federov maintained that these spending items were inappropriate commitments that were not bound by law and that should and could be canceled by the Government. Others in the cabinet disagreed. The Parliament was disbanded at the time. The ex post deficit will depend on how many of the so-called

monetary velocity was approximately 1.2.³ There was no foreign borrowing ($f = 0$) and almost no domestic bond financing ($b = 0.3$ percent). Thus, the equation predicts a monthly inflation rate of:

$$13 \text{ percent} = (11 - 0.0 - 0.3) * 1.2$$

The equation is exactly on the mark for the 13 percent December inflation rate (somewhat by chance to be sure!). Compounding the 13 percent December inflation rate for a 12-month period, the annualized inflation rate was approximately 335 percent.

There are several countries with budget deficits of around 9 percent of GDP, which have modest inflation rates. This is shown in the accompanying Table 1. Why do these countries have low inflation while Russia has a very high inflation rate? Simply, they finance their budget deficits in non-monetary ways, by foreign borrowing and domestic bond financing. (They also restrict the direct financing to the enterprise sector, as Russia must do as well).

This experience in other countries, and the analytical content of equation (4) highlights the superficiality in the current debate about IMF conditionality. The IMF argues that Russia should substantially reduce its budget deficit as a precondition for IMF aid. But we can immediately see an alternative. The IMF could instead mobilize international assistance (its own funds together with funds of the G-7 and international institutions) to help Russia finance the budget deficit in a non-inflationary way, by shifting from monetary to non-monetary finance. In addition, it could help Russia to increase the proportion of the budget deficit that is covered by domestic bonds.

In essence, the choices are shown in Table 2, in two stylized variants. The one I call the "IMF variant" is based on slashing the budget deficit to around 3 percent of GDP.⁴ The "Aid variant," of the kind that I have been advocating during the past two years, is based heavily on shifting the financing of the budget deficit from monetary financing to foreign financing and domestic bond financing. This would allow the budget deficit to remain at around 9 percent of GDP during 1994, and would be consistent with a fall in the inflation rate to around 3-4 percent per month. In the "Aid variant," the foreign financing would amount to around 4 percent of GDP (\$14 billion, assuming a 1994 GDP of \$350 billion), and domestic bond financing of around 2 percent of GDP (up from this year's rate of around 0.3 percent of GDP).

Why is the IMF incorrect in simply pressing for greater cuts in the deficit? Such cuts are economically and politically unjustified. A more nuanced approach is needed. While it is true that many budgetary subsidies could be cut

"arrears" are in fact paid off by the new cabinet.

³Velocity is measured here as the ratio of monthly GDP to the monetary base.

⁴The IMF has not yet made a precise recommendation for 1994, so "IMF approach" signifies the standard procedure of the IMF, not a specific recommendation to this point.

in 1994 (my own estimate is around 4 percent of GDP), it is also true that many areas of social spending must be substantially increased (by around 4 percent of GDP). It is therefore extremely unlikely that Russia could drastically reduce government spending as a percent of GDP this year. On the tax side, there is also little scope for increased revenues. While a few taxes (e.g. energy excise taxes) might be raised, other taxes (such as the VAT) are already at high rates. During stabilization, it is likely moreover that profits taxes will decline, perhaps by several percent of GDP. Russia will therefore do well simply to maintain the tax revenues as a percent of GDP.

The incessant and exaggerated IMF focus on budget cuts (rather than deficit financing) has had three undesirable effects. It has deflected the Russian attention from social spending, by creating the presumption that there is no money available for social spending. How can one think about new social spending if the existing budget deficit is already too high by 6 percent of GDP? Second, the IMF focus on budget cutting has left the West vulnerable to the Russian charge of being insensitive to Russia's economic realities. Third, the IMF approach has stymied realistic compromises inside the Russian Government.

The IMF argues that financing a budget deficit simply postpones the difficulties, while accumulating public debt for the future. Indeed, there is a case for budgetary financing in the form of grants (as in the Marshall Plan) rather than loans. Even if the foreign support comes in loans, however, there is still a very strong case in taking on more long-term public debt at this point. Russia's debt-GDP ratio is approximately 20 percent (\$70 billion of net foreign debt in a GDP of \$350 billion). There is almost no internal indebtedness. Therefore, Russia's stock of government debt as a percent of GDP is less than almost all OECD countries! Russia's foreign debt currently poses a crisis in term of short-run liquidity: the debt cannot be serviced in the next few years because of the urgent fiscal crisis. It is likely to be manageable, however, in the long run. There is therefore further room to borrow now in support of stabilization and consolidation of the reforms.

Despite the importance of Western assistance for budgetary finance, the IMF has failed to acknowledge that a substantial part of the Western assistance program should be steered towards budgetary financing, as a direct weapon in the fight against inflation. While the IMF asserts that roughly \$20 billion in bilateral loans flowed to Russia in 1992-93,⁵ it fails to recognize that such commercial loans to Russian state enterprises were either irrelevant to or actually inimical to stabilization, since they did not help with budgetary financing. In fact, almost all of the loans that came were very short-term commercial loans that supported off-budget import subsidies, and that typically exacerbated the budget deficit, thereby actually raising inflationary pressures in 1993 and 1994.⁶ The IMF rightly tried to stop the use of such credits,

⁵This number seems unrealistically high to me. It should be documented by the IMF.

⁶In a typical transaction during 1992, when most of the loans were made, a Russian trading firm received a credit to import foodstuffs. It then sold the foodstuffs at a very low domestic price. Sometimes the foodstuffs were given

Table 1. Budget Deficits and Inflation, Selected Countries, 1992

<u>Country</u>	<u>Budget Deficit as Percent of GDP</u>	<u>Inflation</u>
Belgium	6.8	2.4
Italy	9.5	5.3
Greece	11.1	15.9
Sweden	7.1	2.3
memo:		
Russia, 1993, Q:IV	9.0	335.0

Source: For all countries except Russia, OECD Economic Outlook, No. 54, December 1993, Table A25, "General government financial balances," and Table A15, "Consumer Prices." For Russia, the budget deficit is for the last quarter of 1993, and a projection of 15 percent per month for a twelve-month period.

Table 2. Budget Alternatives for Stabilization (percent of GDP)

	Budget Deficit		Financed by:
			money bonds foreign
Current	9	-	8.7 + 0.3 + 0.0
IMF variant	4	-	3.0 + 1.0 + 0.0
Aid variant	9	-	3.0 + 2.0 + 4.0

though now it counts them as "foreign assistance"! The actual aid flows during 1992 and 1993 are discussed briefly in an appendix to this testimony.

In 1992, there was zero foreign financing of the Russian budget deficit. The entire foreign financing was either to support off-budget import subsidies (which actually worsened the budget deficit in 1993 and 1994 as explained in footnote 6), or to support technical assistance and grants of foodstuffs, medicine, and a few other commodities (probably less than \$1 billion in total).

In 1993, actual budgetary financing for Russia was probably less than 1 percent of GDP (a full accounting is not yet completed). In mid-1993, the IMF assumed 2.7 percent of GDP in foreign financing of the Russian budget (plus 4.2 percent of GDP in commercial loans to finance off-budget import subsidies), but the assumed foreign financing was basically constituted by the postponement of interest payments on the foreign debt (amounting to 2.8 percent of GDP in postponed payments), rather than by actual flows of money to Russia.

In fact, the IMF systematically understates to the Russian Government the amounts of Western assistance that is potentially available for budgetary financing. When the IMF makes its budgetary recommendations to Russia, for example, it takes into account only IMF funds that are under current negotiation, not future IMF funds that are planned to follow the current program. Thus, when the IMF and Russia were discussing the \$3 billion Systemic Transformation Facility in the Spring of 1993, the IMF refused to incorporate in its formal budgetary recommendations the fact that the \$3 billion STF was supposed to be followed by a \$4 billion standby loan.

In an interesting sentence in a mid-1993 report (Request for Purchase under the Systemic Transformation Facility), the IMF describes Russia's balance of payments as follows:

Russia's external financing requirement (grants and loans from bilateral and multilateral creditors and debt relief, excluding non-FSU states) is projected at about \$43 billion in 1993, including \$3 billion from the Fund. (p. 12)

The \$43 billion mentioned by the IMF is clearly pegged to the G-7's prior announcement of a \$43 billion aid package (\$28 billion in loans and grants and \$15 billion in debt rescheduling). The IMF's statement is very odd, however, in that the Fund's share of the \$43 billion package was supposed to be \$13 billion, not \$3 billion, yet this is not acknowledged even in the Fund's own document.

away to politically powerful local constituencies, where they were resold for a profit. When the loan comes due (mostly in 1993-1995), it is guaranteed by the Russian budget! The Government will have to pay off the loan directly, or will have to give subsidies to the trading firm to pay off the loan. In this way, billions of dollars of so-called "Western aid" actually helped to finance extensive corruption (in the trading firms), while adding to the budget burden during 1993-95. This represents around \$17 billion of the \$23 billion of so-called "aid flows" reported by the IMF.

The IMF says that it is not permitted to "budget" its own funds that have not yet been negotiated. The practical effect, however, is that the IMF pushes the Russian Government to make larger cuts in the budget deficit than are necessary or warranted.

The IMF also fails to stress the importance of domestic bond financing, and to mobilize technical support to raise the proportion of the Russian deficit that can be financed by domestic bonds. IMF programs with Russia have stated that the Russian Government should sell domestic bonds to finance the budget deficit, but the IMF has put almost no real effort into this crucial part of the stabilization process. Rather, it has focused almost all of its negotiating effort on getting Russia to cut the budget deficit. In its 1993 program with Russia, the IMF assumed bond financing at less than 1 percent of GDP.

Because of this past history of aid, Senators, the warnings of Western Governments that Russia will "lose Western assistance" if Russia deviates from stabilization are no longer credible in Moscow. Since there has been almost no real support for stabilization, there is little fear now of a "cutoff" of aid. Of course, the Russians remain very interested in large-scale assistance of the sort that we have offered, but they see little prospect that such aid will ever arrive. Part of the job of the U.S. Government now is to raise our own credibility that in fact there would be significant assistance in the context of a rigorous adjustment program.

To conclude this section, I should mention two other deep shortcomings in the IMF approach. First, the IMF has made major mistakes on straightforward monetary advice. It was one year late in advising Russia to introduce a separate national currency and to disband the "ruble zone." This caused a nearly fatal setback to stabilization in 1992. It also has advised Russia against using a pegged exchange rate as a "nominal anchor" in financial stabilization, contrary to the worldwide experience of recent years.⁷ Second, the IMF has relied almost entirely on fly-in missions rather than on-the-ground assistance in Moscow. Despite its protestations to the contrary, the IMF's contacts with Russian policy officials (especially at the level of division chiefs and directors general) is superficial and generally too brief to be of much help. The IMF had only two residents in place in its Moscow office in 1992, and had only 4 residents in

⁷As World Bank Chief Economist Michael Bruno has concluded in a major review of worldwide stabilization experience:

While monetary targeting with an exchange-rate float has been a plausible policy alternative in stabilization from low or moderate inflations (especially when the safety cushion of exchange reserves does not exist -- as in Bulgaria and Romania), this has hardly ever been the case with successful stabilizations from high or hyperinflations. There are a variety of reasons for targeting the exchange rate rather than a monetary aggregate at the initial stabilization stage -- the instability of the demand for money, the frequency of observation of the exchange rate as a proxy for the price index (on a daily basis), and the more widely and intuitively understood signal of the stability of a key price level (in relation to wages, for external competitive considerations, etc.).

1993. There have also been a very few advisors put into the Russian Central Bank for a few-months period (3 advisors, I believe, in the past two years).

Towards a future assistance program for Russia

It is not yet clear whether Russia will abandon the quest for monetary stabilization. Of course, with the departure of the leading reformers from the government, the prospects look rather bleak in the next few months. On the other hand, the Russian Government is at least paying lip-service to the priority of stabilization. It is possible, though unlikely, that the Russian leadership is sufficiently scared of "Ukrainization" of the Russian economy to be willing to continue on the path of monetary stabilization.⁸

In any case, it is a huge mistake to leave the situation up to the current IMF mission now in Moscow. The IMF lacks the vision and conceptual framework to work out any satisfactory arrangement with the Russian Government. The problem, once again, is not to drop the IMF's goal of low inflation. The problem is to design a framework of assistance to help achieve that goal.

The U.S. Treasury together with its G-7 partners should take over from the IMF the active guidance of the negotiations with the Russian Government. Operationally, the Finance Deputies of the G-7 could be charged with operational oversight, and presumably, Treasury Undersecretary Lawrence Summers would have the lead within the group. The G-7 should put forward its willingness to finance a significant part of the Russian budget deficit (through IMF, World Bank, and G-7 loans) if the Russian Government takes the additional steps that would be needed to bring about real financial stabilization.

The odds are very poor that such an agreement can be reached and implemented at this point given the composition of the Russian cabinet, but on the other hand, the stakes are so high that the possibilities of such an agreement should at least be explored. If such an agreement cannot be reached now, it should at least be tabled by the G-7 in case the leading reformers return to the cabinet when the economic situation deteriorates in future months.

Direct G-7 leadership would accomplish something that the IMF inherently cannot do. By reaching an aid agreement directly between the G-7 and Russia, the Russian leadership (President Yeltsin and Prime Minister Chernomyrdin) will be directly bound to the agreement much more strongly than would be the case with a typical IMF loan (which is signed at the level of the finance minister and central bank chairman). This endorsement of the G-7 support by the senior Russian leadership would strengthen Western confidence to move forward with large-scale aid. In this way, Russia and the West would break free of the trap of "low aid, little reform" and arrive at the goal of "large-scale aid, deep reform."

What would be the contents of a real Western assistance package, if the appropriate circumstances arise? It should be modelled with four components,

⁸Ukraine has inflation rates of 90-100 percent per month, which when annualized amounts to an inflation of more than 200,000 percent per year.

roughly as shown in Table 3. The first component, \$14 billion of budgetary support, would constitute the 4% of GDP budget financing shown in the "aid variant" in Table 2. The other \$14 billion for industrial restructuring would involve the wide range of projects already on the drawing board for modernization and restructuring of key sectors of the economy, including military conversion, energy, and agriculture. Most of this financing would come from the World Bank, the EBRD, and the export credit agencies. In addition, Russia would receive further fiscal relief by a multiyear debt rescheduling and a ruble stabilization fund, designed to be held as reserves to back an early pegging of the exchange rate (which has played a key feature in the stabilization programs in Israel, Mexico, Poland, Argentina, and Estonia in recent years).

A final plea: Glasnost in the IMF

IMF performance will never be properly understood, much less improved, until the IMF is subject to the same kind of public scrutiny as the U.S. Congress, the Federal Reserve Board, and other public institutions vested with the public trust. As I prepare this testimony, and peruse IMF documents in my possession as a former advisor to the Russian Government, literally every document is stamped "Confidential." Senators, you cannot independently scrutinize the IMF's operations, much less ask informed questions that might be prompted by the lack of clarity in IMF reports, under such conditions of confidentiality.

The IMF responds to criticisms of its secrecy by saying that each member government has access to all the reports. This is not enough. It does not constitute independent public scrutiny. Moreover, the IMF states that member governments would not be frank if they knew that IMF documents would thereafter circulate in the public domain. This too is an inadequate defense of the IMF's retreat to confidentiality. Borrowing from the IMF is a privilege, not a right of member governments. The world's taxpayer dollars (and in the case of Russia, the world's physical security) are at stake in each IMF decision. If governments want to receive IMF funds, they should be prepared to open the IMF loan agreements to public scrutiny, perhaps after a short delay (as in the case with the Federal Open-Market Committee of the Federal Reserve Board). The U.S. Congress, in its turn, should require that U.S. public funds can be put at risk in IMF loans only if IMF documents are available for public scrutiny.

Table 3. Basic structure of recommended Western aid package

1)	\$14 billion	Russian budget financing
		\$5 - 8 billion IMF funds
		\$3 billion World Bank funds
		\$3 - 6 billion direct G-7 aid
2)	\$14 billion	Industrial restructuring projects
		\$10 billion export credits directed at long-term restructuring
		\$2 billion EBRD (with co-financing)
		\$2 billion World Bank funds
3)	Multiyear debt rescheduling in Paris Club	
4)	Ruble stabilization Fund (\$6 billion, to be held as reserves, from General Agreement to Borrow)	

Appendix. A Review of Economic Assistance during 1992-93

The past two years have been nothing short of a debacle from the point of Western assistance to Russia. In both years, the West promised a large-scale aid program (\$24 billion in 1992 and \$28 billion in 1993, not counting debt rescheduling), and in both years, only a tiny fraction of the aid actually arrived.

As seen in Table A.1, the IMF was called upon to provide \$9 billion of assistance in 1992, and in fact delivered \$1 billion. Even that overstates the aid, since the \$1 billion was granted on the surrealistic condition that it could not be spent, but rather had to be held in the bank as reserves! In 1993, the IMF was to deliver \$13 billion, and in fact delivered \$1.5 billion. Of course, the IMF says that "additional finance did not materialize because the Russian authorities were unable to implement appropriate stabilization and structural reform policies." This, I have argued, is a faulty assessment. The IMF is also responsible for the shortfall, for failing to devise a sensible framework that would have matched Russian stabilization efforts with external financing of Russia's budget deficit.

The World Bank and EBRD also failed to meet the targets set by the G-7. In 1992, these two institutions were to deliver \$1.5 billion in loans, and in fact delivered nothing. In 1993, these institutions were to deliver \$5 billion, and in fact lent just \$0.5 billion. In the same year, the World Bank lent approximately \$5 billion to China.

The IMF claims that bilateral assistance totalled \$20 billion during 1992 and 1993. This sum is doubtful and has not been precisely quantified in public documents by the IMF. It is much higher than the figures believed by many Russian financial authorities. In any event, most of it does not constitute real assistance. Almost all of the money was in the form of short-term credits at commercial interest rates lent to Russian state-trading bodies, with Russian sovereign guarantees. The loans were dissipated in subsidies to selected regions and to corruption. These loans provided almost no budgetary support; they were not part of a consistent assistance program (the IMF never tried to coordinate the flow of funds or to integrate the funds into an assistance program); and in fact, these funds are now a significant burden on the budget as a large proportion of the loans are already falling due!

"Truth in advertising" would require that the IMF specify the breakdown of assistance in the following ways: grants versus loans; the maturity structure of the loans and the terms of repayment; the proportion of financing to the Russian budget; and the proportion of financing that was part of monitored programs of Western assistance. Then, the world will see clearly that there has been almost no aid flows during 1992 and 1993, especially in comparison with Russia's needs and in comparison with the levels of assistance advertised by the Western Governments and the IMF. My own estimates are that Russia received approximately \$3.5 billion of budgetary support over the two-year period.

Table A.1. Official Financial Assistance to Russia, 1992-93
(A = announced; D = delivered)

	1992		1993		1992-1993	
	A	D	A	D	A	D
IMF	9	1	13	1.5	14	2.5
World Bank, EBRD	1.5	0	5	0.5	5	0.5
Bilateral ⁹	13.5	14	10	6.0	21	20.0
Total	24	15	28	8.0	40	23.0

Memo items:

Aid from international agencies	10.5	1	18	2.0	19	3.0
Budgetary support ¹⁰		0		2.0		2.0

Source: IMF press release, February 1, 1994.

⁹Includes \$2.5 billion of promised relief on interest payments that was not formally granted in 1992.

¹⁰Estimate of aid that was directly in support of budgetary financing, not counting debt rescheduling. In 1993, approximately \$2.5 billion could be used for budgetary support: \$1 billion of the IMF loan, \$0.5 billion of the World Bank loan, and approximately \$0.5 billion of Western support.

PREPARED STATEMENT BY PETER REDDAWAY

PROFESSOR OF POLITICAL SCIENCE, GEORGE WASHINGTON UNIVERSITY,
DISTINGUISHED FELLOW, U.S. INSTITUTE OF PEACE

As a political scientist, I have drafted my statement as a political analysis which will hopefully facilitate our discussion of the Russian economy and the effect of IMF and World Bank policies. Attached to the statement are two recent articles of mine from the New York Times and The Boston Globe, which elaborate my views and which you may want to include in the record.

Let me first present a summary of my views, before I lay some of them out in more detail. I have argued since August 1991 that while conditions in Poland were probably suitable for the policies of "shock therapy" to succeed there, Russian conditions were very different (Paper to U.S. Congressional conference, Budapest, 1991). If shock therapy were to be introduced in Russia, as advocated at that time by Jeffrey Sachs and others, it would be premature—and it would fail. The political and economic culture of Russia had not yet matured sufficiently for such therapy to work. Unlike Poland, there was nowhere near a popular consensus in favor of it.

A few months later, in October 1991, urged on by Sachs and others in the West, President Yeltsin nonetheless decided to adopt a shock therapy program with the aim of stabilizing the Russian economy. The IMF, acting for the G-7 governments, became its principal foreign partner. However, by Spring 1992, after lifting many price controls, the Yeltsin administration found itself facing fierce domestic opposition to the program. So, in order to ensure its own survival, it felt compelled to back away from much of the medicine prescribed by the IMF. But neither side abandoned the whole enterprise. The Russian government kept trying, periodically, to meet the conditions it had agreed on with the IMF, even though it usually failed by wide margins. And the IMF tried to bend its rules of conditionality, but not beyond reasonable limits. The predictable result of all this was that only a small proportion of the planned assistance was handed over by the IMF.

Now, in the last few weeks, the government has clearly decided—despite occasional rhetoric to the contrary—to renounce what it sees as the bane of "market romanticism." It has resolved to stop trying to meet the IMF's politically unfeasible conditions, to liberate itself psychologically from its humiliating feeling of dependency on foreign taskmasters, and to turn instead to some traditional, non-market means of controlling the economy.

However, these decisions by the government are almost certain to move it "out of the frying-pan—into the fire." For although the reforms have not created a true market, they have destroyed most of the means by which the government *used* to control the economy. So *non-market-oriented* methods won't work either. Russia is thus floundering in a no-man's-land between the old "administrative-command" system and a so far unattained market.

The probable result will be hyperinflation, to be followed not by a recall of the economic reformers, but by a further growth of the political instability that has been highlighted up to now by the coup of August 1991 and the incipient civil war of October 1993. Central government is likely to lose much of its remaining control over the country, and Russians may be forced to struggle for survival in an increasingly regional framework. After a year or two of this, the ground could be ready for the emergence of an ultra-nationalist movement much more dynamic than that led by Zhirinovskiy today. Such a movement could capitalize on the prevailing sense of humiliation and impoverishment, and might well succeed in reuniting a fragmented country.

That is a summary of my views—views which, incidentally, in a Russian context, are not unusual. Even Yegor Gaidar, the sober-minded former prime minister, developed his own variant of them last month, when he described the growing threat of a vicious Russian fascism (*Izvestia*, January 20).

In case my analysis seems to exaggerate the extent of Russian disillusion with Western recipes, let me look first at evidence from the December elections and then at some recent statements by top politicians. In the elections, the one party which in principle stood for radical economic reform, Russia's Choice, got 15 percent of the popular vote. But in its electoral campaign it de-emphasized reform, and its leader, Gaidar, actually took up some anti-reform positions. He advocated the introduction of protectionism to shield Russian producers from foreign competition, and he backed Yeltsin's imposition of curbs on banks more than half-owned by foreigners.

If one adds to the 15 percent for Russia's Choice the vote received by three mildly reformist parties, the reformist total comes to 34 percent. By contrast, the three main hardline parties got 43 percent. While there were some policy differences between the hardliners, generally speaking they were against economic reform, against aid from the West, sceptical of, or hostile to democracy, and, in general,

militantly anti-Western. The leader of the party with the highest vote (23 percent), Zhirinovsky, has already made clear on the world stage his extreme anti-Westernism and his intention to be a dictator. As for the city and regional elections that have just begun, early indications are that they will probably be an even bigger triumph for the hardline parties than were the national elections, and an even greater disaster for reformers (*Izvestia*, February 2).

Russian hardline groups have been profoundly anti-Western for the last seven years. They have believed Gorbachev and then Yeltsin to be agents of the West, consciously working to destroy the USSR and then Russia. Since 1992 their anti-Westernism has gradually been taken up by groups nearer to the political center. Now it has begun, so far in fairly mild forms, to affect Russian officials.

If, moreover, the U.S. administration has indeed decided—as reported by *The Washington Post* on February 5—to change its policies of backing Yeltsin uncritically and pressuring the IMF to help him at almost any cost, then the rhetoric of Russian leaders will surely sharpen dramatically. The mutual recriminations which have already begun will intensify—and not only between Russia and the West, but also between warring factions on either side who are keen to offload responsibility for the debacle onto each other. An example of the latter type is the recent polemics between Professor Sachs and the director of the IMF, Michel Camdessus.

The whole of this tragic cycle—the West pushing Russia into a therapy program it was not ready for, the therapy therefore failing, and one of the results being bitter recriminations between East and West—is, I have to say, exactly what I warned against in 1991, before the cycle began (paper to Budapest conference).

Let us look, then, at the moderate—to date—rhetoric of the Russian government. Recently the prime minister announced (through a spokesman) his view that “the mechanistic transfer of methods of Western economies to Russian soil does more harm than good” (ITAR-TASS, January 21). The First Deputy Prime Minister, Oleg Soskovets, then complained that international organizations were exerting political pressure on Russia, even though they had, as yet, provided “no tangible economic aid.” “As soon as we start talking about price regulation,” he continued, “voices can immediately be heard saying that this is not a pro-market measure, and that neither the West nor the IMF will approve of it. But why should we use other people’s minds in our own country?” (Interfax, RFE/RL, January 26) Even Foreign Minister Andrei Kozyrev, when rejecting some Western criticism, warned tartly on January 27 that Russia “will not listen to (the West’s) lessons and lectures.”

Let me now explain more fully why do I not share the optimism often expressed by the U.S. administration that the adoption of a new Constitution in Russia will usher in a period of greater political (if not economic) stability. There are several reasons. First, the Constitution is unfortunately a document of very limited legitimacy—and therefore authority. The final amendments to it were made unilaterally by Yeltsin. It was published only a month before the December referendum that approved it. During that month Yeltsin tried (unsuccessfully) to halt the strenuous criticism of it from most points on the political spectrum, by banning such criticism and imposing censorship on the media. In the referendum only a third of the total electorate actually voted for the Constitution, and if many of those voters soon decide that it has not reduced the gridlock in Russian government, they will probably lose faith in it. Given the lack of respect that the new parliament is already showing for it, this development is likely.

Second, Yeltsin himself has been provoking some of this disrespect—and thus political instability—by his often dismissive attitude to the legislature. In addition, he has become increasingly erratic in his general behavior, saying one thing (especially to foreign leaders like President Clinton) but doing another, disappearing from Moscow for days on end, failing to resolve urgent matters quickly, and ignoring others. He is widely thought to be suffering from depression as well as excessive drinking and a heart problem. The executive that he heads is both permeated by corruption and chaotically organized. And his presidential administration has become greatly inflated in size, overlapping and duplicating in many respects the parallel executive headed by the Council of Ministers.

Third, instability is generated by the deterioration of the economy. Recently, for example, the non-payment of workers’ wages for weeks or even months at a time has led to a spate of strikes, strike threats, and go-slows. Even before the government’s turn away from the market, most of the economic indicators were negative. The GNP had been almost halved in four years, tax revenues were low, investment was very low, capital flight was alarmingly high, monopolies were strongly entrenched, and inflation was set to spiral again, following Yeltsin’s pre-election promises of handouts to various social groups and sectors of the economy. More recently, the military were given an expensive new target for total personnel of 2.1 million

men, instead of 1.5 million. And on January 24 the Prime Minister's chief analyst told Reuters that to cover all these additional payments the government had instructed the Central Bank to print 17 trillion roubles in the first quarter of 1994, instead of the previously envisaged 7 trillion. He also calculated that the new emissions could raise the budget deficit for 1994 to 25 percent of GNP.

And fourth, the strong centrifugal forces operating in Russia work against stability by making it quite uncertain which government laws and regulations are being observed in which parts of the country (if any). Senior politicians have been sounding the alarm on this point. The minister for regional policy, Sergei Shakhrai, for example, sees the weakness of the ruble leading in 1994 to regional conflicts involving economic separatism and resort to the primitivism of inter-regional barter (ITAR-TASS, January 24). The former chief executive of the Security Council, Yuri Skokov, who is now an industrial leader with declared aspirations to replace Yeltsin as President, agrees with the widespread view that economic reform and social policy will henceforth be determined by each region for itself. This is because in his view the Kremlin has neither the administrative levers, nor the revenue, to perform such functions (*Nezavisimaya gazeta*, January 28).

If, then, instability is growing, is Yeltsin taking steps to counter it? Yes—he is systematically taking the main levers of power into his own hands, with the apparent aim of securing his own position and adopting a more authoritarian style of rule. Thus he has increased his control of television and two key news agencies, he has divided the state security organs into separate agencies and subordinated them to his apparatus, and has initiated plans to take similar action with the police and the military. He has sharply trimmed the powers of parliament, has drafted a law to do likewise to the Constitutional Court, has purged the Council of Ministers and the Security Council of most of their reformers, has moved to increase the range of curbs on political parties, has promoted conservatives in his own apparatus, and has adopted a more assertive and nationalistic foreign policy.

For most of these moves Yeltsin appears to have the support of military, police, and security leaders, and of the small class of wealthy new owners who have managed to acquire the former assets of the state, and want to have these often ill-gotten gains secured for them. However, I do not believe that Yeltsin or any other leader will, however hard he tries, *succeed* in imposing an authoritarian order on Russia over the next year or two. The forces of public order are too weak, divided, and demoralized, and the regional leaders are too jealous of their newly won autonomy, for such attempts to succeed.

Faced with such a volatile and uncertain situation, what can the West do? Even at the best of times its influence on such a huge and diverse country is bound to be very limited. But now, with what many Russians perceive as the failure of economic and political reforms inspired or even imposed by the West, with the words capitalist and democrat having become suspect or even offensive to a growing number of them, with the government developing a firm if not yet militant rhetoric for use against the West and the IMF, the West suddenly has very *little* influence. Aid without strings would probably be accepted by any government except one led by Zhirinovskiy. But the IMF and the World Bank do not give such aid.

As the new economics minister, Alexander Shokhin, said frankly on January 24, IMF loans and macro-stabilization must now be off the agenda. Beyond that, World Bank aid to (and Western investment in) the private sector is becoming even riskier than hitherto, because of the dangers posed by increasing lawlessness and Mafia activity, and by the growing threat that future populist governments at the central or local level will expropriate private assets. As a successful Russian businessman recently said, echoing a widespread fear: "Of course, here you can never be sure what's going to happen next, because a new reactionary government may step in and nationalize everything" (*Washington Post*, January 2, 1994).

The aid least likely to be wasted or embezzled is investment in people—teaching them skills that will be useful almost whatever regime is in power. Aid-givers should in most cases bypass governments of all sorts, to avoid corruption, and try to identify groups and individuals at the grass roots who are both promising and honest.

The overall picture is regrettably bleak. Over the last six years I have often been chided for excessive pessimism regarding first Gorbachev and the USSR, and now Yeltsin and Russia. But alas, much of the pessimism seems to have been justified. As a lifelong Russophile I hope my assessment proves to be too gloomy. But as an analyst, I fear that it will not.

PREPARED STATEMENT OF JUDE T. WANNISKI
PRESIDENT, POLYECONOMICS, INC.

Mr. Chairman and Members of the Committee, thank you for inviting me to testify at these important hearings. I am Jude Wanniski, president of Polyconomics, Inc. Polyconomics, based in Morristown, New Jersey, is a consulting firm advising our financial and corporate clients about political-economic developments both domestically and internationally.

It should be no surprise that great controversy surrounds the economic policies followed by the governments in Moscow during the past five years. How does one convert a command economy of significant size and complexity to a market economy? In all of history, never before has this problem of political economics confronted the global experts. There is nothing in the textbooks to suggest how it might be done.

My study of the problem at Polyconomics began in early 1989, when the Soviet Embassy in Washington, DC, asked my opinion of how it could be accomplished. My interest is also tied to the fact that my father's parents came here from Poland and the Ukraine, my mother's from Lithuania. In the years since, I've made several trips to Moscow at the invitation of the Gorbachev and Yeltsin governments. I've also had several dozen meetings with representatives of the Soviet and succeeding Russian government, in Washington and New York, to discuss this central issue. For a brief period in early 1992 I was an official advisor to the Yeltsin finance ministry under an agreement signed by Yegor Gaidar. All, I might add, *pro bono*. Here, briefly, is how I saw the central problem, which has two parts, then and now:

1. In a command economy, wages, prices and capital allocation are dictated by a committee of experts who process information flows through state channels. In a market economy, these are determined through market mechanisms which have evolved to process vastly greater information flows through private channels. How should these mechanisms be created in a country starting from scratch? At what pace and in what sequence?

2. In a communist society, almost all capital is in the possession of the state. In a capitalist society, almost all capital is possessed by individuals. In converting from the former to the latter, by what method should the state transfer most of the capital to its citizens? Could this method be financed by the state through cash flow, or should the conversion be treated as a one-time capital expense, to be financed by an increase in the public debt?

If these questions could have been answered, even in crude form these past few years, the transition would have been much smoother, well on its way, as in China, to a trial-and-error completion. We would not be here today in this committee hearing. Unfortunately, these questions were not even remotely asked in the way I have posed them. By its very nature, "shock therapy" as it has come to be called, involved an indiscriminate leap from one system to another. Last September, when I was in Beijing at the invitation of the People's Bank of China, I asked the deputy director of the bank reform department, Mrs. Wu Xiaoling, what she thought of the situation in Russia. She shook her head and said, through a translator: "You do not burn down the old house before you build a new one." Think how painful it would be here at home, to scrap the entire welfare system that has evolved over the past half century, on the assumption that people would somehow land on their feet as the market adjusted.

How, then, did I answer those two questions five years ago?

First, I accepted the idea that the command mechanisms had to remain in place until market mechanisms had been created to replace them. Those people who agreed with me in Moscow are those characterized in our news media as "hard line communists unwilling to give up the old system. These were essentially the parliamentarians who were blown up in last October's political crisis. They are also essentially the people subsequently elected in the new parliament.

Second, I argued that before market mechanisms could take over, the value of the currency had to be fixed. That is, a modern market cannot evolve without a banking mechanism, which in the United States is the financial service industry in its entirety. It seems hard to believe, but for the last 75 years, there have been no banks in the Soviet Union, taking deposits and making loans.

A Russian financial service industry—including banks, stock and bond markets, insurance companies and credit unions—can only be built around a *stable unit of account*, i.e., a ruble of known and predictable value. In the same way, it would be impossible to build a new house without a fixed unit of measure—a yardstick all of the workers would understand to be 36 inches in length. A fixed unit of measure is always superior to a floating unit.

This fixing of the ruble is a critical prerequisite regarding the transfer of capital from the state to the individual. It's far easier for the state to seize the property of the citizens in all its forms than it is for the state 75 years later to redistribute this wealth. It becomes almost an impossible task when the national accounting unit is afloat, changing from day to day.

In 1989, when I first looked into the situation, I was informed by the Soviets that the biggest problem was their "600 billion ruble overhang." They told me the problem had been identified by the best economists of the west, at the World Bank, the IMF, and the U.S. Treasury Department. This "overhang" was the amount of rubles either in circulation or in state depositories. In monetarist parlance, it was said to be an inflationary threat, an excess in the money supply.

My immediate argument was that these 600 billion rubles represented the entire capital stock of the nation held by individuals, the accumulated savings of the population. This represented only 5 percent of the total capital stock of the nation—the land, the minerals, the industry, the infrastructure, and the housing stock all being held in state ownership. At the time, these 600 billion had a purchasing equivalent of \$150 billion, which meant the wealth per capita in private hands was roughly \$500. If individuals were to acquire the bulk of state-owned assets in the conversion process, even at a rate of ten cents on the dollar, 600 billion rubles would not go far.

Yet in the five years since, the entire savings of the people of the former Soviet Union, all \$150 billion, was wiped out by the inflation induced by the IMF/World Bank team and its concern about that ruble overhang. The value of the ruble has been cut to 1500 per dollar now from 4 per dollar then. The value of the \$500 per capita life savings was reduced to \$1.33. The shock therapy policies designed by western economists were entirely responsible.

In China, which has been successfully making the transition to a market economy, the value of the currency has gone to only 8 yuan per dollar from 4 yuan in the same period. The People's Bank of China remains determined to keep this exchange rate fixed, which will insure that the inflation rate there is the same as it is here. Most importantly, the stable unit of account in China has permitted the steady evolution of a financial services industry, beginning with curbstone trading of equity and debt—a kind of klondike capitalism reminiscent of early America. This enables workers to collateralize their future income streams, borrowing from each other in order to start their own businesses. It enables these new entrepreneurs to make contracts, producing goods and services and exchanging them in the knowledge they will be paid back over time with a currency that has held its purchasing power.

How has shock therapy caused the opposite to occur in Russia? By pushing the successive Gorbachev and Yeltsin governments into leaving the old system of controls before the ruble was stabilized, the World Bank/IMF teams caused these governments to steadily reduce the purchasing power of the ruble. This was the purposeful, conscious policy of currency devaluation for which these bureaucratic financial institutions have become infamous throughout the developing world.

The well-meaning intent was to have prices and wages determined by the law of supply and demand, instead of dictated by the state. The problem the IMF/World Bank teams failed to take into account is that the value of real wages in a nation is determined by the amount of capital available. If there are three countries that exist only by digging holes in the ground—one with backhoes, one with shovels, one with sticks, obviously the wages will be highest, and holes the deepest, in the country with the most capital. In Russia, a country with almost no capital, freeing prices and wages in a leap of faith would reduce the work force to digging holes with their bare fingers. In a mature, capitalist economy like ours, government wage and price controls quickly erode the efficiency of capital by blocking information signals and by rewarding inefficient private enterprise and punishing the efficient. In Russia, where the state owns the commodities it is pricing, fixing or even cutting the price by decree *as part of a plan toward a market economy* does no harm.

By proceeding according to the textbooks of Harvard, Stanford and Yale, the Russian government indeed began lifting the price of its most important commodity—petroleum—in January of 1991. The objective was to get it to the world market price. At the time, it sold for 120 rubles per metric ton in the domestic market, or about \$4 per barrel. The IMF/World Bank team argued it should be allowed to float to the world level of about \$20 per barrel at that time. The idea, apparently developed by Lawrence Summers, then chief economist of the World Bank, now Under Secretary of the U.S. Treasury for International Affairs, seemed logical: By selling oil domestically at a price one-fifth what it would fetch on the world market, Moscow was squandering resources. Yet the political reality was that if it raised the price fivefold, the people of Russia could not afford to buy petroleum or petroleum

products, including a fertilizer for the crops. The practical effect of Dr. Summers logic would be the devastation of the Soviet economy by pricing petroleum products out of the reach of the people. As far as I can tell, Dr. Summers and his former colleague at Harvard University, Jeffrey Sachs, are still fully in agreement on this keystone of the shock therapy strategy.

If oil were to soar by 500 percent, to 600R per metric ton, the Soviet national industrial complex would have to shut down, unable to buy any oil from the domestic oil industry—the largest in the world. The economy would quickly grind to a complete halt and the unemployment rate would climb to chaotic levels. In January 1991, while rejecting this total shock, the Gorbachev government gave in to IMF/World Bank demands for *movement* toward the world price. It raised the domestic price to 200R from 12 OR, a 60 percent increase.

Even at that rate, Soviet industry could not buy petroleum inputs without credit from the Gosbank, the USSR central bank then managed by Viktor Geraschenko, the same gentleman who now presides over the Russian Central Bank. The IMF/World Bank team protested, as did other prominent western economists, arguing the issuance of credits would be inflationary. The Gosbank, then controlled by the Supreme Soviet, ordered the credits issued in order to prevent the bankruptcy of the state enterprises.

Again and again, the IMF/World Bank team demanded that the price of oil be increased, in order to have it equilibrate with the world oil price. But each time the government complied, the Central Bank issued more credits, and the value of the ruble sank further. The government changed hands in late 1991, Mr. Gorbachev giving way to Mr. Yeltsin. The process accelerated, and at the time of the October crisis last year, the domestic price of oil had climbed to 35,000R per metric ton. At the moment, it is at 50,000R per metric ton. Like a cat chasing its tail, the ruble price is no closer to the world price, still about \$4 per barrel.

All that has been achieved is that the Russian people had been digging holes with shovels and now are digging with sticks. The IMF/World Bank continues to insist the petroleum price be lifted yet again, to more than 200,000R, if Boris Yeltsin is to get the foreign aid he has been promised, and as Mikhail Gorbachev was promised before him. As far as I know, the shock therapists in our government and universities are in complete agreement with them.

A few shock therapists have recently criticized the IMF, but not for the reasons that have caused such grave difficulties for Moscow and the people of the former Soviet Union. The criticism has been based on the IMF's refusal to release aid monies absent Moscow's compliance with its conditions. The argument is that if Moscow had the promised funds—roughly \$1.5 billion—it could cut off the flow of credits to Russian industry, watch them go bankrupt, and hand out the western aid in the form of relief. The amount of money is, of course, trivial compared to the lost production of the former Soviet Union and the present Russian federation. The amount would at best provide a Big Mac, Pepsi, and large fries for each citizen, if none of the funds were chewed up by the bureaucratic intermediaries here and in Russia.

If we wish to see what would have happened if Moscow in the last five years had followed the IMF/World Bank plan to the letter, we need only look at Yugoslavia. Five years ago, Yugoslavia was still unified, relatively prosperous, its ethnic and religious social groups getting along with each other, trading and even inter-marrying. At the urging of the IMF, the government devalued the dinar and raised the price of oil. When the economy slumped and revenues fell, Belgrade raised taxes on IMF advice, to balance the budget. In protest, Croatia and Slovenia split away. In the mid-1980s, one dinar exchanged for the equivalent of \$22. Today it takes several million dinars to acquire just one dollar. The ethnic and religious social groups have been hurled back centuries in time, into a dark age, and are at each other's throats.

The situation in Russia is not yet hopeless. My repeated advice to the governments in Moscow and the central bank has been to concentrate on restoring the people's confidence in the currency. Only then could the conversion to a market economy be financed without inflation, by having the people willing to hold the government's ruble bonds. Instead of insisting upon a balanced budget, as have the IMF/World Bank economists, I recommended the government welcome a sizable increase in its public debt, vastly increasing the dollar value of the ruble overhang. By definition, an increase in the public debt transfers wealth from the state to the people, which is what we are supposed to be doing in the first place. As the economy gets rolling, this public debt could easily be paid down through state sale of its enormous assets to ordinary people, at deep discounts.

How would the people's confidence in the ruble be restored? I recommended the finance ministry follow the example of Alexander Hamilton, who established the credit of the United States among lenders at home and abroad by pledging to pay down all existing debt obligations at par—even though they were trading at 15 cents

on the dollar in the first years of the administration of George Washington. In December 1991, in Moscow, I advised Yegor Gaidar of Hamilton's insight that a new nation should not begin life by declaring bankruptcy. I also told him that there are few examples in history where a government that had significantly devalued its currency survived. Ordinary people do not appreciate the confiscation of their life savings. Unhappily, the die had been cast.

From this vantage point, I am more optimistic now about the future of the Russian economy than I have been for some time. Those chiefly responsible for the inflation, Mr. Gaidar and Boris Fyodorov, the economics minister, have been cut loose by President Yeltsin in the wake of the December elections. It is inconceivable that the government could restore confidence in the currency if those seen by the population as the authors of the inflation remained in power. Both Gaidar and Fyodorov insisted that Viktor Gerashchenko was the culprit as head of the central bank. Their friends in the western press have characterized him as an incompetent. I've met him several times these last five years and believe him to be not only competent, given the alternatives, but also a committed reformer who has disagreed with the shock approach from the start.

Prime Minister Victor Chernomyrdin, who appears to be in confident control of the government, has issued pronouncements about fighting inflation via wage and price controls that sound silly to our western ears. But as I have already indicated, in this unique situation, this is the correct approach. It appears there will be no further increases in the petroleum price. At a dinner meeting at the Russian Embassy early last December, prior to the elections, I urged the government to consider lowering the price of oil, even cutting it by half. This would reverse the inflation process in a painless way, enabling industry to acquire petroleum without fresh credits from the central bank. This would also increase the value of the ruble, by increasing its purchasing power relative to oil, as if the government were on an oil standard.

In this positive atmosphere, with a strengthening currency, the Finance Ministry would find it much easier to contemplate the issuance of government bonds to finance the budget deficit. I would again recommend, as I have in the past, issuing 10-year bonds that would increase in value as they approached maturity, which would reward those who buy early with significant capital gains. *My suggestion is that the ruble's value at the end of the 10-year period be defined as a specified weight of gold, which is also how I believe Alexander Hamilton would have designed the bond issue.*

The idea I'm sure seems strange to this committee, but remember that in this unusual situation we are trying to think of creative ways to transfer capital from the state to the people. Long before these government bonds matured, the Russian economy would be growing as fast as China's. Public debt issued now would seem trivial by then, as the vast human and mineral resources of Russia were liberated by the market mechanisms that will have been created. In a period of ten years, the growing wealth of the Russian economy would gradually minimize the impact that a five-fold increase in the oil price would have on commercial life.

This type of monetary reform is central to the success of any plan for conversion that the Yeltsin government might contemplate. It is, though, not sufficient. The tax system designed with the help of the IMF/World Bank team, which is now in place, follows logically from the assumption that conversion must be financed out of current resources, the cash flow of tax revenues into the national treasury. It is as if a newborn baby were forced into the work force at infancy, expected to contribute steeply progressive revenues to family income. The rates of taxation on business and personal income are confiscatory, as the shock therapists have scrambled to meet budget demands amid a collapsing economy. Taxes in Russia are at the top of the prohibitive range of the Laffer Curve, which is simply the law of diminishing returns as applied to tax policy. The only businesses that can really flourish are those which are protected from the tax collectors by the criminal mafia that has grown in this environment.

If the correct monetary reform were announced, strengthening the value of the ruble as the state's commodity pricing deflated, the impact on the tax system would also be beneficial. Instead of "bracket creep" silently increasing real rates of taxation, as we observed here in the United States during the inflation of the past generation, the monetary inflation would cause the reverse to happen—a reverse creep that would reduce real rates of taxation. Incipient business enterprise and unborn business would find it possible to exist in the official economy, rather than go underground to escape the tax collector. Again, one of the reasons China's economy is booming is that its tax system has been designed with the help of the Chinese diaspora in Hong Kong and Singapore, island economies whose booming economies are built around reasonable rates of business and income tax.

Here, too, the political fallout from the December elections has produced a promising change in personnel. The new economics minister is Alexander Shokhin, who has in the last 18 months traveled several times to Beijing to discuss the China method of conversion. I would hope he has come to grasp the key feature of China's success in its agricultural sector, which Russia has not yet replicated. In 1978, in a single decree, the communes of China were turned into cooperatives. Communes of 15,000 or 20,000 people were suddenly free to decide themselves how they would organize their work, what they would plant, where they would sell. As long as they paid their taxes, they could do about anything they wanted. There was no template issued from Beijing.

Moscow has also turned its communes into cooperatives, but with the unfortunate bad habit continued of issuing central instructions on how they must operate. One size fits all. In China, democracy has been flourishing at the grass roots since 1978, as the cooperatives elect their leaders, who decide what to do based on information flows from the markets, and from their constituents. Those who make bad decisions are not re-elected. Across China, the co-ops which have grown fastest are the show-cases for the others. Delegations constantly criss-cross the regions studying those which have done the best. The cross-fertilization of ideas not only increases the efficiency of the economy, it has also cultivated the expansion of a democracy that grows from the bottom up. If you think of it, this is the kind of experimentation that has existed in the United States from our earliest days. Each state that tests policy has to set itself against the successes of others. We also advance by learning from the failures of our neighbors. In the same way, China has learned from the failure in Russia just as Russia can now learn from China's success.

What should United States policy be toward Russia? It should be clear that as long as we cling to the shock-therapy formula, U.S. and Western influence in Russia will decline and Eastern influence will expand. There is no more stomach in Moscow for the kind of pain and suffering inflicted thus far. The protest vote for Zhirinovsky was a wake-up call for Boris Yeltsin. It should be treated as such by Washington and other western capitals. My own guess is that the Russian people have seen the worst of it, and from now on will be inching their way forward with the China model. Zhirinovsky not only reminded us of the emergence of Adolf Hitler in Germany. It also reminded us that Germany was at the time, like the Soviet Union today, a defeated power, victimized by a harsh Versailles Treaty after World War I that *did not want to see Germany prosper*. As a nation today, I think we have to make up our minds whether we want our former adversaries in Moscow to prosper. There has been some ambivalence, I think, among our opinion leaders and within our government.

The question of foreign aid remains. Clearly Moscow will not take a dime of IMF money if it has attached the IMF's impossible conditions. If it were up to me, I'd extend the funds with no strings attached, treating the Russians as if they were responsible adults. I'd only ask for a careful accounting of how the funds were used. I'd hope they would not use the funds to build a social safety net, with each citizen finding therein one Big Mac, a Pepsi, and a large fries. I'd recommend they would use the \$1.5 billion to buy U.S. Treasury bills, socked away in a ruble stabilization fund, backing up their own issuance of domestic ruble bonds. They could do the ruble stabilization without foreign aid, but it would make it easier, and would be appreciated. It would be therapeutic, without the shock.

Visit to a Maelstrom

By Peter Reddaway

WASHINGTON President Clinton is to arrive on Wednesday in Russia, where anti-American attitudes are taking hold in significant sections of society for the first time in history. What Communism tried mightily to do but could not, ill-advised American policies of the last few years have achieved. If the President is not careful, he could make things worse.

His Administration, of course, sees things differently. Mr. Clinton and his aides say their Russia policy is a great success. Strobe Talbott, the ambassador-at-large to the former Soviet Union who is to become the Deputy Secretary of State, has been consistently upbeat about Russia's reforms, even in the wake of the elections of Dec. 12. "If we are active and effec-

tive in our support for reform," he wrote in *The Boston Globe* on Jan. 2, we can help the peoples of the former Soviet Union "achieve peace, prosperity and democracy."

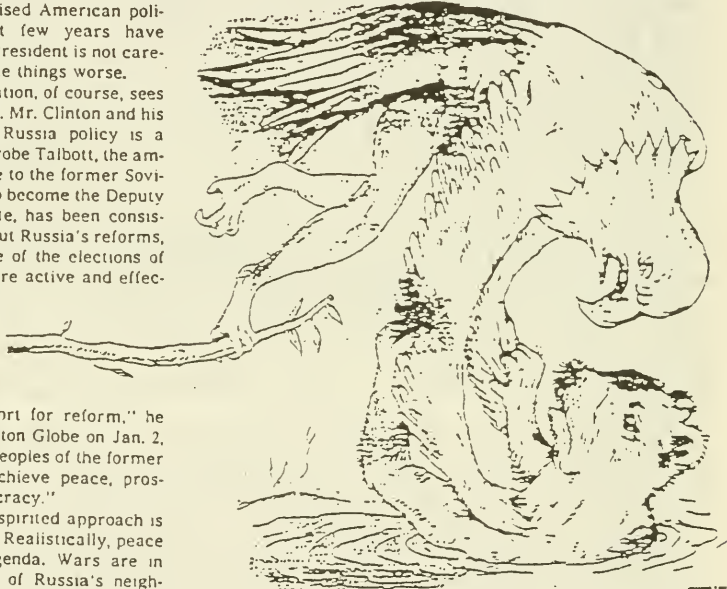
This generous-spirited approach is built on illusions. Realistically, peace is not on the agenda. Wars are in progress in four of Russia's neighbors, and more such conflicts are likely in the future. In Russia, after two major coup attempts in two years, democracy hangs by a thread.

Contrary to Mr. Talbott's assertions in the same article, Russia has not "made real progress toward financial stabilization" — inflation is 20 percent per month — nor will reformers "constitute the largest block of deputies" in the new Parliament: deputies from the four reformist factions total 164, while those from the three hard-line parties total 182.

In such volatile and deteriorating conditions, the first rule of diplomacy is surely to avoid getting dragged into a maelstrom. In particular, it is un-

wise to stake too much on any one individual or group. You are almost certain both to lose your stake, to anger the other players and to get blamed for internal interference.

Yet this is what the U.S. has been doing in Russia — in spades. First the Administration embraced the erratic Boris Yeltsin and his radical economic reformers with uncritical fervor. More generally, it has often spoken as if it were making Russia's domestic policies jointly with the Russian Gov-



approach plays into the hands of the hard-liners, who have long maintained that the U.S. deliberately destroyed the Soviet Union through its puppet Mikhail Gorbachev, and is now doing the same to Russia.

Peter Reddaway is professor of political science at George Washington University and a fellow of the U.S. Institute of Peace.

Washington

through its puppet Mr. Yeltsin.

I want to be clearly understood. Unlike some critics, I am not a socialist who hopes Mr. Yeltsin will fail because his goal is building capitalism. I am a lifelong Russophile who would be very happy indeed if I thought that current American policy were realistic and that the brave efforts of Russian reformers were going to bear fruit in the near future.

Alas, I do not. Mr. Yeltsin is right, as he has done in recent weeks, to compare Russia to Weimar Germany and to stress that it came to the brink of civil war last October. If Mr. Talbott had pushed his Panglossian line to Russian voters rather than the U.S. Congress, he would have been shouted off the stage for being out of touch with their daily struggle for survival.

Thus Mr. Clinton's decision to adopt the slogan "more reform, more support" for his Russian trip was unwise. Russians are not in the mood for a big new dose of reform, and any government that embarked on that path seriously — not just rhetorically, for Western consumption — would commit political suicide. It could also precipitate a civil war.

Mr. Clinton's line "more support" is superficially attractive. But it is irresponsible to advocate a social safety net that would consume huge amounts of money the Russians do not have and the West is clearly not going to provide. To claim otherwise will soon disillusion America's remaining supporters in Russia, and infuriate the powerful groups that say U.S. policy is motivated by malice or, at best, naivete.

The Administration correctly points out that backpedaling on reform will not get Russia out of its fearful predicament. But Russians have to find this out for themselves and decide what to do next. Otherwise they will blame us, not themselves or the legacy of Communism.

Russia is gradually becoming ungovernable, but because it is the largest and most complex country in the world, outsiders cannot have more than a marginal effect on it. Even if the \$24 billion conditionally offered by the Group of Seven were somehow pumped into Russia tomorrow, it would not change the situation.

The biggest shadow over the Russian economy is the likelihood that inflation will soon escalate into hyperinflation. This stems from Mr. Yeltsin's generous pre-election promises regarding state credits and income raises, and from his recent decision to reverse previous commitments to cut back the military to 1.5 million. The populist majority in the new Parliament will scarcely allow him to renege on these promises, even if he wants to.

In every area of public life, no turnaround point is in sight. Popular tolerance of constantly declining living standards will not last forever, especially now that talented demagogues like Vladimir Zhirinovskiy have, predictably, appeared on the scene.

In such a difficult situation, what is Mr. Yeltsin's strategy? Behind the boilerplate assurances about "continuing the reforms," which the U.S. has trustingly accepted at face value, a new course toward authoritarianism is quietly being prepared. This offers Mr. Yeltsin his best (though still not good) chance of staying in power for another year or so.

The same course is favored by two groups on which he now heavily relies, the military and the small new class of wealthy owners who have manipulated the privatization of state assets and need their often ill-gotten gains to be made more secure.

Authoritarian trends are every-

where: the recent revamping of the security ministry so that it answers directly to the President; resubordination of two big news agencies, *Izvestia* and *Novosti*, to government control; abolition of the local soviets; curbs on foreign banks, and the intimidation through surrogates of the new Parliament.

But I doubt that authoritarianism will work at this stage, under Mr. Yeltsin or any other visible leader. The police and the military are too divided and demoralized, and the regions are too jealous of their autonomy. Thus the likely prospect for 1994-95 is one of increasing powerlessness and instability at the center, with Russians struggling to survive in an increasingly regional framework.

In such a complex and volatile situation, U.S. policies based on unjustified optimism will have baleful effects. Russian leaders are encouraged to share our illusions, depend too much on an uncertain flow of aid from us, overestimate our ability to save them when the crunch comes and forget that democracy in Russia is doomed if the Government drifts into neo-imperialism. The Clinton Administration's credibility with its taxpayers and its foreign allies will suffer, and anti-Americanism in Russia will take many years to alleviate. And Russia's neighbors will suffer from our one-sided sensitivity to Russian concerns.

Thus Mr. Clinton would be wise to treat his Moscow visit as an opportunity for learning, reassessment and meeting a wide range of people. He should quietly reduce American involvement with Mr. Yeltsin; avoid being didactic or patronizing, and focus mainly on long-term projects like nuclear safety, humanitarian aid, peacekeeping and training Russians in skills that will be useful whatever regime may be in power. []

Boston Globe Jan. 14, 1994

Clinton's hopes for reforms under Yeltsin ignore the realities

PETER REDDAWAY

As President Clinton meets with Boris Yeltsin and other Russian leaders in Moscow, critics of US policy toward Russia are asking themselves: Will Clinton and his team come off believing that, despite temporary difficulties, Russian democracy and reform are flourishing? If they do, the consequences are likely to be regrettable. The American public and US allies abroad will be mobilized on an issue with wide implications. Also, as a senior US official working on Russia has suggested, if pessimism about Russian prospects should prove to be correct, a policy that has been prompted by the administration as a great success will turn out to have been a failure.

Clinton and his point man on Russia, Strope Talbott, have based much of their recent optimism on the adoption by referendum of a new constitution that they and, in his optimistic moments, Boris Yeltsin believe will give Russia more political stability. It is difficult to share this view. Since the final amendments to it were made unilaterally by Yeltsin and since he tried to ban public criticism of it during the month between its publication and the referendum, and since most of the political parties

criticized it strongly as an instrument for facilitating his dominance over the Legislature, it is very much a "Yeltsin constitution." This means that it is unlikely to survive long after his departure from power.

Also, key parties in the new lower house, or Duma, show clear signs of planning to try to amend the constitution in ways inimical to Yeltsin. They may well command majority support. Such attacks will be facilitated by the fact that only a third of the electorate voted for the constitution, and many of those voters probably did so not because they understood its complex provisions, but because they hoped that any constitution would be better than no constitution. If they now find that the new document does not relieve the level of strife, gridlock and instability in government, they will lose faith in it.

Contrary to assertions by members of the Clinton and Yeltsin administrations, Yeltsin will not be able to simply crush aside opposition to his policies in the Parliament. Nor, probably, will he be able to disband it, even though he has the constitutional authority in certain circumstances to do so. Rather, he will be continually taunted, as he has been already, that whereas the despotism possesses a new mandate from the people, he does not. Out of fear they will say, he reneged on the promise he gave

in September to stand for reelection. Thus there is a strong whiff of bluff in "Astorian" like that by senior official Anatoly Adamushin, who claimed that "both Yeltsin and the head of the government can do without the Duma in governing the country, especially if it proves to be only an instrument of obstruction."

That the Duma will do a lot of obstructing is now certain. It appears to have a majority in favor of backpedaling economic reform and risking hyperinflation. It is likely to demand a full investigation of Yeltsin's use of military force to disband the old Parliament. And it may make its mark on foreign policy by, inter alia, withholding ratification from a number of important agreements, including the Open Skies and the START-2 treaties. Strong forces in the Duma are anti-Western and anti American, and Vladimir Zhuravsky, in particular, gained voters' support by attacking the West for what he called its deliberate humiliation of Russia.

Equally troubling are the increasing levels of erratic behavior and bluff in Yeltsin's statements and the thereby pervasive corruption and interference, feuding within his administration. Yeltsin is increasingly thought to be suffering from depression as well as excessive drinking.

While living standards continue to slide another major problem is that Russia's regions and republics show few signs of curbing their disregard for Moscow. Indeed, on Dec. 24 the Republic of Bashkortostan adopted a new constitution that blatantly contradicted Russia's constitution. In particular, Bashkortostan's new autonomy actually gave supremacy over federal laws. A similar state of affairs has existed de facto, if in varying degrees, in all of Russia's territorial units and negates the rule of law.

The fact, plus businessmen's fear of assets being nationalized by a future populist government, helps to explain the low level of foreign investment in the Russian economy. Finally, the situation regarding public health, crime and environmental protection continues to get worse.

Yeltsin's response - so far only limited to all this adversity is to prepare himself to rule Russia in authoritarian style. The attempt to do so will almost certainly fail. Nonetheless, in recent weeks he has been subordinating directly to himself as many sections as possible of the mass media and the security organs, and persistent reports circulate to do the same for the general staff of the armed forces.

Not surprisingly, then, the dominant mood in Russia - whatever parties are chosen for election - is one of confusion, bitterness and aggression. The media provide little or no evidence of optimism about 1994. If Clinton nonetheless comes back in April, he will be acting by his own judgment alone that of the Russians.

Peter Reddaway is professor of political science at George Washington University and a distinguished fellow at the US Institute of Peace in Washington.

DONALD W. RIEGLE, JR. MICHIGAN, CHAIRMAN

PAUL S. SARABANES, MARYLAND
 CHRISTOPHER J. DODD, CONNECTICUT
 JIM BASSER, TENNESSEE
 RICHARD C. SHELBY, ALABAMA
 JOHN F. KERRY, MASSACHUSETTS
 RICHARD H. BRYAN, NEVADA
 BARBARA BOXER, CALIFORNIA
 BEN Nighthorse Campbell, COLORADO
 CAROL MCKELEY BRAUN, ILLINOIS
 PATTY MURRAY, WASHINGTON

ALFONSE M. D'AMATO, NEW YORK
 PHIL GRAMM, TEXAS
 CHRISTOPHER S. BOND, MISSOURI
 CONNIE MACK, FLORIDA
 LAUCH FAIRCLOTH, NORTH CAROLINA
 ROBERT F. BENNETT, UTAH
 WILLIAM V. ROOTH, JR., DELAWARE
 PETE V. DOMENICI, NEW MEXICO

United States Senate

COMMITTEE ON BANKING, HOUSING, AND
 URBAN AFFAIRS

WASHINGTON, DC 20510-6075

STEVEN B. HARRIS, STAFF DIRECTOR AND CHIEF COUNSEL
 HOWARD A. MERRILL, REPUBLICAN STAFF DIRECTOR

February 23, 1994

The Honorable Lawrence Summers
 Under Secretary for International Affairs
 Department of the Treasury
 Washington, D.C. 20220

Dear Dr. Summers:

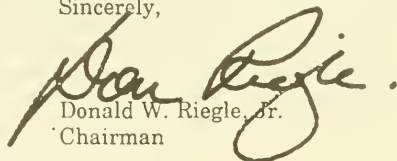
I would like to follow up on the issue of IMF information disclosure that we touched upon during your testimony to this Committee on February 8, at the hearing on IMF and World Bank policies towards Russia and their impact on the Russian economy.

As you may recall, I suggested that, consistent with IMF policies, it may be useful for the United States government to release data and information furnished to it by the IMF. Such openness would allow people to more effectively monitor IMF policies and draw well-informed inferences as to why the IMF makes certain decisions.

You concurred at the hearing that "there's a need for more openness and we ought to push things that way." You also stated that our government would support reforms in IMF procedures that will--within the next 90 days--result in greater disclosures of the IMF's process as it deals with individual countries.

I would appreciate your pursuit of this matter to ensure that there is in fact greater public disclosure of information about IMF decision making in the near future. Please keep me updated as to your progress.

Sincerely,


 Donald W. Riegle, Jr.
 Chairman

DONALD W. RIEGLE JR. MICHIGAN CHAIRMAN

PAUL S. SARBANES MARYLAND
 CHRISTOPHER J. DODD CONNECTICUT
 JIM SASSER TENNESSEE
 RICHARD C. SHELBY ALABAMA
 JOHN F. FERRY MASSACHUSETTS
 RICHARD H. BRYAN NEVADA
 BARBARA BOXER CALIFORNIA
 BEN NIGHTHORSE CAMPBELL COLORADO
 CAROL MOSELEY-BRAUN ILLINOIS
 PATTY MURRAY WASHINGTON

ALFONSE W. DAMATO NEW YORK
 PHIL GRAMM TEXAS
 CHRISTOPHER S. BOND MISSOURI
 CONNIE MACK FLORIDA
 LAUCH FAIRCLOTH NORTH CAROLINA
 ROBERT F. BENNETT UTAH
 WILLIAM V. ROTH JR. DELAWARE
 PETE V. DOMENICI NEW MEXICO

United States Senate

COMMITTEE ON BANKING, HOUSING, AND
 URBAN AFFAIRS

WASHINGTON, DC 20510-6075

STEVEN B. HARRIS STAFF DIRECTOR AND CHIEF COUNSEL
 HOWARD A. MENELL REPUBLICAN STAFF DIRECTOR

December 3, 1993

The Honorable Lloyd Bentsen
 Secretary of the Treasury
 Main Treasury Building
 15th and Pennsylvania Avenues, N.W.
 Washington, D.C. 20220

Dear Mr. Secretary:

Senator Bennett recently visited Moscow and informed us of several disturbing observations upon his return. The principal concern he has raised is that the current policies of the World Bank and International Monetary Fund (IMF) with regard to providing international financial assistance may be endangering Russia's viability. The stability of the Russian economy and its successful transition to a market-based economy is a subject of direct concern to the United States and will likely be a topic of discussion between President Clinton and Russian President Yeltsin at their upcoming summit.

In this context, we believe the impact of the World Bank and IMF policies upon Russia warrant careful examination. According to authoritative sources, many of these economies are on the verge of implosion. For example, inflation may be running as high as 500% annually, while output could decline by more than 15% this year, and capital flight reached a reported \$10 - \$20 billion in 1992 alone. The severe economic hardship suffered by the Russian people since the demise of the Soviet Union nearly two years ago can be seen in the collapse of the ruble's market value, from six to a dollar to approximately 1,200, wiping out the value of savings and pensions of the population and fueling hyperinflation.

Despite these negative developments and their ominous political implications, the World Bank-IMF financial assistance to Russia continues to be contingent upon an economic reform approach which stresses removal of price controls, currency devaluation, tax increases and budget stringency. An advisor to the Russian government, Harvard Professor Jeffrey Sachs, who has been closely associated with what some pundits have termed the "shock therapy" approach, recently suggested that the IMF has been too

harsh in its imposition of austerity policies, particularly with regard to deficit reduction, floating exchange rates, and the lack of short-term liquidity.

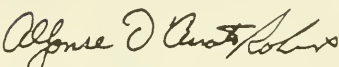
As you know, under the rules of the Senate, the Senate Committee on Banking, Housing and Urban Affairs has jurisdiction to "study and review, on a comprehensive basis, matters relating to international economic policy...and report thereon from time to time." The Committee also has jurisdiction over other matters relating to economic stabilization and export and foreign trade promotion.

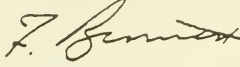
We are concerned that current World Bank/IMF policies toward Russia have the potential to strangle its economy which, in turn, may have an adverse impact on our own U.S. economy, as well as the world's economy, and our national and international economic security.

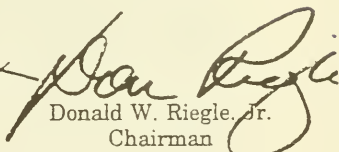
As a result, we would appreciate your thorough review and analysis of World Bank/IMF policies toward Russia and specifically responses to the following questions: (1) What is our government's assessment of the current Russian economy? (2) To what extent are World Bank/IMF policies contributing toward improving their economy or contributing to its further deterioration? (3) What is the likelihood of a deterioration of the Russian economy causing an adverse impact on the U.S. economy?

We would appreciate your response to the concerns raised in this letter no later than January 17, 1994. If you have any questions with regard to this letter, please feel free to have your staff contact Steven B. Harris or Howard A. Menell of the Senate Banking Committee staff, or Robert C. Cresanti of Senator Bennett's staff.

Sincerely,


Alfonse M. D'Amato
Ranking Member


Robert Bennett
Member


Donald W. Riegle, Jr.
Chairman

cc: Honorable Warren M. Christopher



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

February 2, 1994

SECRET-ARY OF THE TREASURY

The Honorable Donald Riegle
United States Senate
Washington, DC 20510

Dear Don:

Thank you for your letter asking my views on the economic situation and the roles of IMF and World Bank policies in Russia. I recently returned from accompanying President Clinton to Moscow, where I met with many top Russian officials and had a close look at the situation. Treasury Under Secretary Lawrence Summers accompanied me to Moscow, and I understand he will testify February 8 on Russia before the Senate Banking Committee. I also understand our staffs have had the opportunity to exchange views on Russian economic developments and on your questions.

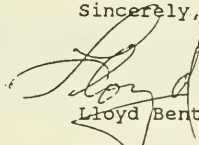
Let me say briefly that Russia has made significant progress in its transition from a command economy to a market-based system. Its two greatest successes have been in enterprise privatization and price liberalization. There has also been some progress in reducing fiscal deficits and cutting inflation, but Russia has much further to go in this area. Although the situation appears still to be fluid at this time, I am hopeful that progress on economic reform will continue under the new Russian government.

We believe that Russia needs continued and faster reform in order to firmly close the doors on the communist past and unlock the benefits of a market economy, and we have assured Russian leaders that genuine reform will continue to be supported by western assistance. We have also encouraged the Russians on the one side and the IMF and World Bank on the other, to intensify their cooperation so that financial support can flow more freely to support accelerated reform.

At the same time, the Russian population faces very real hardships during this period of economic transition, and the current social safety net in Russia is inadequate. We have encouraged Russian officials, in cooperation with the IMF and World Bank, to develop a more comprehensive social benefits infrastructure to better cushion vulnerable groups.

The issues raised in your letter are very important ones that merit thorough examination and that I have only touched briefly upon. Both Larry Summers and I gained considerable insight into these issues during President Clinton's Summit with Russian President Yeltsin. I have asked Larry to make sure that his testimony provides in-depth analysis of all your questions.

Sincerely,



Lloyd Bentsen

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
LAWRENCE SUMMERS

Q1. Professor Goldman stated on page 1 of his testimony:

"It is misleading to focus on whether or not this or that set of policies or a more generous outpouring of support would have saved the Russian reform effort. To provide perspective it is necessary to remember that for three years now the German government has been spending over a hundred billion dollars a year to resuscitate East Germany, so far with only meager results."

Do you agree that Western aid programs are only peripheral to economic development in Russia?

A1. It is true that economic developments in Russia will depend most on the actions of the Russian government and domestic institutions. Even large amounts of foreign assistance cannot be of help Without a government committed to the appropriate policies. While foreign investment is very important to long-term growth, mainly because it brings with it desperately needed know-how, Russia needs to mobilize its domestic capital into productive enterprise. Instead, capital is currently flying out of the country to foreign havens.

On the other hand, I believe strategically-targeted assistance can be tremendous helpful to a country which is committed to reform. In the short-term, untied balance of payments assistance, such as that offered primarily by the IMF, can help meet budgetary expenditures which otherwise would be filled by inflationary money emissions or go unfilled leading to excess social tension.

In the longer term, technical assistance programs and financial support for structural reforms can help transform inefficient enterprises into firms able to survive in a market environment. This includes World Bank loans, EBRD loans or investment and bilateral technical assistance or equity. Treasury believes that equity will be the most useful form of support, since it brings both capital and know-how. For this reason, we have created enterprise funds which are financing start-up enterprises and restructuring of newly privatized firms.

Q2. In his prepared testimony, Professor Sachs contends that the IMF's insistence on Russia cutting its budget deficit has been misplaced. Such cuts, he contends, are economically and politically unjustified. Instead he calls for shifting the financing of the budget deficit from monetary financing, which leads to inflation, to foreign financing and domestic bond financing.

Do you think his recommendations are correct? If not, why not?

A2. We agree that foreign assistance can and should contribute to financing Russia's budget deficit. However, we agree with the IMF that Russia must also substantially reduce its budget deficit. If the deficit is not cut, foreign financing will be needed again next year and the year after. IMF resources would soon be exhausted and Russia would be left with the burden of higher debt service payments. The IMF's role is to help countries overcome temporary imbalances, but the countries themselves have the primary responsibility. To make an exception for Russia would be financially unsustainable and inconsistent with the IMF's institutional objectives and procedures. It would also be seen as unfair to other countries who must meet normal IMF criteria for financial support.

The IMF has nonetheless attempted to accommodate the special needs of the economies in transition. In 1993, at the urging of the U.S. Administration, the IMF introduced the Systemic Transformation Facility (STF). The STF was designed to facilitate IMF lending for economies in transition by offering more flexible preconditions for initial IMF support. Last June Russia borrowed \$1.5 billion under the STF.

Cutting the budget deficit is desirable not only in order to reduce inflation, but also to allow the necessary economic restructuring to take place. Subsidies to failing state-owned firms only delay restructuring while burdening healthy sectors of the economy.

In addition, the following considerations are relevant:

- Reducing budget deficits is not the only criterion on which the IMF bases its lending policies towards Russia or other countries. Under the 1993 \$1.5 billion IMF loan to Russia, Russia agreed to make numerous other economic reforms that would improve its economic and budgetary situation. For example, it agreed to eliminate all export quotas by the beginning of 1994 except those on oil products and gas, which would be eliminated by the end of 1994. It also agreed to begin implementing its bankruptcy law. However, these reforms were not implemented.
- Mr. Sachs also recommended in his testimony that bilateral western assistance make a substantial contribution to

financing Russia's budget deficits. However, we are all aware of the limitations placed upon us by our own budget constraints.

- We would agree that Russia should develop its domestic bond market in order to substitute non-inflationary bond finance for inflationary money-creation. Western technical assistance can help Russia develop a domestic bond market, and the IMF has worked with Russia on this. The Administration is also seeking to place an advisor with the Russian Finance Ministry to help develop the securities market. However, the main condition required for the Russian government to be able to sell substantial volumes of government bonds domestically is an environment of legal certainty, political stability, and trust in the value of the ruble -- conditions that only Russia can create.
- In his testimony Mr. Sachs stated that while many budget subsidies could be cut, social spending must be substantially increased. We have also recommended that Russia increase social spending as it cuts subsidies to firms. In this context it is worth noting that the World Bank proposed a \$500 million loan to help Russia improve its social safety net. However, the Russian Government has up to now shown no interest in this loan.
- Mr. Sachs points out that other countries have budget deficits similar in size to Russia (on the order of 10% of GDP), yet have low inflation because they can rely on foreign and domestic bond financing instead of money creation. However, there is widespread agreement that those countries' budget deficits are not sustainable and must be reduced.

Q3. Can Russia restructure its budget spending and revenues without first receiving a firm commitment of Western aid? How can Russia get this commitment?

A3. The IMF has sought to work with Russia on its 1994 budget. It stands ready to provide a second \$1.5 billion STF loan on the basis of a solid 1994 budget and other reforms.

If Russia implements an IMF-agreed budget and economic reform program, substantial further assistance would be available in 1994 under an IMF standby loan and also under World Bank lending. Disbursal of a standby loan would be conditioned upon Russia adhering to an economic adjustment program agreed upon with the IMF. In that sense, the IMF cannot make an unconditional commitment to further assistance, but Russia can be assured that continued progress in reform would be met with new IMF support.

Q4. Professor Goldman contends in his prepared testimony that Russia needs more grants and credits -- but in extending such aid we should be careful not to compromise the efforts of the IMF. Thus, he concludes, if special more lenient terms are instituted for Russia, the European Bank for Reconstruction and Development would be a better instrument than the IMF.

Do you agree with Professor Goldman? If not, why not?

A4. We should assist reforms where they are implemented. For example, Russia's privatization program has been extremely successful in freeing enterprises from state control. We have responded with real assistance -- both technical support for the privatization program and financial assistance such as that available through the newly created Russian American Enterprise Fund and the Fund for Large Enterprises in Russia.

The IMF and EBRD have very different goals. The IMF is primarily concerned with facilitating macroeconomic stabilization, while the EBRD is offering project support. Russia, as a member of the IMF, is entitled to draw on IMF resources under the appropriate conditions. The newly-created Systemic Transformation Facility (from which Russia drew \$1.5 billion in 1993) is an example of the flexibility which has been provided to Eastern Europe and the FSU.

However, IMF assistance is conditioned upon Russian policies -- most prominently, the pursuit of sound fiscal and monetary policies. The Russians have been less successful on implementing sound macroeconomic policies than on their structural reforms. Therefore, larger amounts of IMF assistance have not been forthcoming.

On the other hand, sectoral reforms have continued. Both the World Bank and the EBRD can offer targeted assistance to help ensure sectoral reforms succeed. Through the middle of 1993, the EBRD had provided more than \$550 million in loans and \$15 million in investments. Projects have included such activities as rehabilitation of oil fields, improvement of a local telecommunications network, technical assistance to improve the privatization process and creation of a Small Business Fund for investing in new ventures.

Q5. You stated in your prepared testimony that:

"The liberalization of prices and economic activity initiated by former Deputy Prime Minister Gaidar eliminated the long queues that had plagued the Russian people for decades...now goods are widely available throughout Russia."

Some observers contend that the queues have disappeared because few can afford to buy what is available. What do you think of that observation?

A5. The presence or absence of queues has nothing to do with whether the population has become richer or poorer. Queues arise when prices are not free to balance supply and demand. When prices are allowed to adjust queues will disappear -- this holds equally for poor and rich countries.

The queues in the former Soviet Union were a result of too few goods being sold at artificially low prices, with consumers forced to spend hours searching for goods and standing in queues (an exception was the special stores where only the Nomenklatura and those favored by the state could shop). This was a form of rationing that signaled hidden inflation and indicated that real incomes were far lower than official measures.

The replacement of queues and special privileges by a price-based system brings real gains to the Russian population and economy:

- Consumers no longer have to spend hours hunting for shops where goods are available and then waiting in line. In this sense "rationing by price" is less wasteful than "rationing by queue."
- Often goods were simply not available under the previous system. Now they are, though they may be expensive relative to income.
- Equating supply and demand on the basis of price is fundamental to a democratic market economy. It allows production to respond to the needs and wants of consumers and unlocks new potential for efficiency and growth.
- We can already see signs of a better alignment between what consumers want and what is produced. For example, although overall industrial production fell by 16% in 1993, production of televisions and refrigerators -- goods that consumers wanted -- actually increased.

It is also not true that consumers are becoming steadily worse off. In 1993 real wages are estimated to have risen by about 10%, despite a drop in real GDP.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM PROFESSOR PETER REDDAWAY

Q.1. Dr. Summers stated in his testimony that: "The liberalization of prices and economic activity initiated by former Deputy Prime Minister Gaidar eliminated the long queues that had plagued the Russian people for decades . . . now goods are widely available throughout Russia."

Mr. Wanniski, in contrast, contended that ending price controls before market mechanisms were in place was a mistake and has impoverished many Russians.

Have the queues disappeared because few can afford to buy what is available?

A.1. In the large cities goods are fairly widely available; less so in small towns and rural areas. There aren't many queues in the large cities, because many people cannot afford any but the cheapest items. Many Russians have been impoverished in 1991-1993 and have to spend 80-90 percent of their income on food. Some have to sell household objects to get enough money for food.

Q.2. Professor Goldman stated on page 1 of his testimony: "It is misleading to focus on whether or not this or that set of policies or a more generous outpouring of support would have saved the Russian reform effort. To provide perspective it is necessary to remember that for three years now the German government has been spending over a hundred billion dollars a year to resuscitate East Germany, so far with only meager results."

Do you agree that Western aid programs are only peripheral to economic development in Russia?

A.2. Yes. But the answer is complex. Briefly:

One. For such a large country no realistically conceivable aid program could play a major economic (as opposed to psychological) role.

Two. The aid program of the last two years has in my view actually been deleterious. It was fundamentally misconceived: Russia was not ready for "shock therapy," either culturally or in terms of infrastructure. The conditions the IMF had—with Russia's agreement—to impose were always politically impossible to meet. The program has been deleterious not only because the aid actually delivered has been largely wasted or embezzled, but also because of the program's psychological effects. It encouraged a continuation of Soviet dependency attitudes: previously the Russian people felt that the Soviet state had to provide for their well being; now the West would be providing for it. No extra effort was required from them.

Three. Now that the Western aid program is seen by the Russian people and government to have failed, many (not all) Russians have developed some or all of the following attitudes: the West betrayed us; it only pretended to help us; it really wanted to destroy the USSR and then Russia, and to humiliate us; its main aim was to turn us into one of its colonies, producing cheap raw materials for its benefit; the experiences of the last two years prove that Russia is not like the West, it is not suited for a market system or democracy. These attitudes were forcefully articulated by the 3 main hardline parties, especially Zhirinovskiy's, in the elections of De-



ember 1993 and explain why those parties got 43 percent of the popular vote, compared with the 15 percent received by the only strongly reformist party, Russia's Choice.

Q.3. In your view, to what extent did the success of hardliners in the December 12, 1993 elections result from a longing to return to the old system versus merely a signal for course changes to the reformers?

A.3. Some Russians want to go back to the old economic system, if only temporarily, as a way (unrealistic in my opinion), they hope, of stabilizing the economy. Most probably don't know *what* they want, but voted for the hardliners as a protest against (a) their feelings of impoverishment, (b) the corruption of government officials at all levels, (c) the frightening growth of crime and the Mafia, (d) the government's kowtowing to the West on economic, military, and foreign policy matters, (e) the government's failure to give them a *sense of hope about the future*, to alleviate their deepening fears that everything is falling apart and no-one can stop it.

Q.4. What trends do you see with respect to the Mafia and the military in Russia? Could this have any implications on reform efforts?

A.4. "The Mafia" is made up of a number of powerful syndicates. Nowadays, officials either belong to these syndicates, or are under a significant amount of control by them. So the officials usually take decisions in line with the Mafia's interests. The Mafia strongly believes in creating and enforcing monopolies, and is generally efficient at doing so. This greatly impedes the creation of a free market. Its psychology is in many cases that it intends to make big profits now, i.e., for as long as it can get away with it, and to get out of the country quickly, the moment an anti-Mafia government comes to power—which could happen at any time. Hundreds of Mafia people and politicians have already purchased (or been given as bribes) houses in the West, partly for this purpose. (See, for example, the *Financial Times* article of February 8, 1994, about their real estate purchases in London.)

The military are becoming more and more corrupt and linked to the Mafia, as they struggle to survive with reduced government funding. Yeltsin's recent decision to raise their manpower level from 1.5 million to 2.1 million derives from his desire (a) to woo them politically, so that they will, he hopes (almost certainly vainly), support him when the next coup attempt comes along, and (b) his desire to pursue a more assertive, nationalistic foreign policy, especially vis-a-vis the formerly Soviet states around Russia's periphery. Russia is in no position, economically, to spend more on its military. It needs to spend *less*. Yeltsin's current policy therefore goes directly against economic reform: it deprives the government of resources needed to pursue economic reform.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM MARSHALL I. GOLDMAN

Q.1. Dr. Summers stated in his testimony that: "The liberalization of prices and economic activity initiated by former Deputy Prime Minister Gaidar eliminated the long queues that had plagued the

Russian people for decades . . . now goods are widely available throughout Russia."

Mr. Wanniski, in contrast, contended that ending price controls before market mechanisms were in place was a mistake and has impoverished many Russians.

Have the queues disappeared because few can afford to buy what is available?

A.1. Both Dr. Summers and Mr. Wanniski are partially correct. More goods are available on shelves throughout Russia but supplies still are erratic. Certainly stores are not as fully supplied as they would be in the West even when dollars were being charged for the goods as was the case until the dollar became banned as a currency of exchange. This, in part is due to supply problems; it is also due to production problems but it is also a consequence of the Mafia which sometimes disrupts supplies. In any case there are many more goods on the shelves than was true prior to January 1992.

At the same time the Russian reformers made a mistake by moving too quickly to end price controls. They should have more private shops in place, more private farms, more private industries. Because they did not, those who were operating made very high profits which served to attract the Mafia which has led to the supply disruption. One of the big tasks in fact is to move very quickly to the creation of a private sector. That is not the same thing as de-nationalizing or destatizing the formerly owned state enterprises. Many of the now destatized industries operate much as they did before.

Q.2. "Although you've downplayed the impact of financial support on speeding the reform effort, can such assistance ease the pain of the people during transition? Could this in turn ensure more support for the reform effort?"

A.2. Certainly outside financial support would be helpful. The problem is that as things now stand, the Russians do not have in place workable institutions that could utilize that money effectively. The danger is that outside loans will simply join the capital flight outside the country which now amounts to approximately a billion dollars a month. The trick therefore is to find ways to inject funds that avoid going through the central government and are not assigned to specific projects. Even then there will be problems, but certainly the Russian American Enterprise Fund makes more sense than providing macro support to Moscow for something like a ruble stabilization fund or to finance a budget deficit. In addition, after the Russian American Enterprise Fund there should be a Russian American Farm Fund and a Russian American Marketing Fund to help create those new institutions which must be in place before there will be any effective reform.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM JUDE T. WANNISKI

Q.1. Have the queues disappeared because few can afford to buy what is available?

A.1. In a sense, yes. When price controls ended, prices rose until the supply of goods matched the *effective* demand—the purchasing power available to consumers. The purchasing power of all consumers is dependent upon the total amount of capital available to combine with labor. A laborer working without tools (capital) must necessarily have a tiny real income. Because the state possesses most of the capital, and because inflation has wiped out the monetary capital of the people—their life savings, the purchasing power of all consumers is tiny. This was the unforeseen effect of shock therapy, which did not anticipate the importance capital scarcity would have on effective demand when price controls were ended. The correct strategy would be to *first* transfer state capital to the citizenry, by lowering the prices the state charges for its capital assets, the most important of which is oil. In Poland, because the citizens had more capital than their counterparts in the Soviet Union, the number of people able to buy goods is greater, but standards of living have not returned to where they were under Polish socialism.

Q.2. Do you agree that Western aid programs are only peripheral to economic development in Russia?

A.2. Worse than that. By holding out the promise of aid in exchange for compliance with the conditions of shock therapy, the West has caused the impoverishment of the Russian economy. Russia would have been better off to plan its own way to capitalism, as it is now doing, and as the Chinese have from the start. If we were to assist Russia at this point with financial resources, the best use of funds would be to *lend* Russia the use of a ruble stabilization fund. Russia could stabilize the ruble without such a fund, but it would be easier in establishing the credibility of the Yeltsin government among its own people if the U.S. participated in the stabilization strategy. I continue to believe the people will buy ruble bonds at low interest rates if the bonds were designed to appreciate in value the closer they came to maturity. On the surface, this seems costly to the state, but we must remember the primary object of any conversion process is to transfer the collective wealth of the state to individual citizens.



ISBN 0-16-044231-1



9 780160 442315

90000



